

**7535-01-U**

**NATIONAL CREDIT UNION ADMINISTRATION**

**12 CFR Parts 702, 703, 704, 709, and 747**

**RIN 3133-AD58**

**Corporate Credit Unions**

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Final rule.

**SUMMARY:** NCUA is issuing final amendments to its part 704 rule governing corporate credit unions. The major revisions involve corporate credit union capital, investments, asset-liability management, governance, and credit union service organization (CUSO) activities. The amendments establish a new capital scheme, including risk-based capital requirements; impose new prompt corrective action requirements; place various new limits on corporate investments; impose new asset-liability management controls; amend some corporate governance provisions; and limit a corporate CUSO to categories of services preapproved by NCUA. In addition, this rulemaking contains conforming amendments to part 702, Prompt Corrective Action (for natural person credit unions); part 703, Investments and Deposit Activities (for federal credit unions); part 747, Administrative Actions, Adjudicative Hearings, Rules of Practice and Procedure, and Investigations; and part 709, Involuntary Liquidation of Federal Credit Unions and Adjudication of Creditor Claims Involving Federally Insured Credit Unions. These amendments will strengthen individual corporates and the corporate credit union system as a whole.

**DATES:** This rule is effective [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

**FOR FURTHER INFORMATION CONTACT:** David Shetler, Deputy Director, Office of Corporate Credit Unions, at telephone (703) 518-6640, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314; Ross Kendall, Staff Attorney, Office of General Counsel, at the address above or telephone (703) 518-6540; or Paul Peterson, Associate General Counsel, at the address above or telephone (703) 518-6540.

## **SUPPLEMENTARY INFORMATION:**

### **I. Background.**

In January 2009, NCUA solicited public comment on whether comprehensive changes to the structure of the corporate credit union (corporate) system were warranted. 74 FR 6004 (Feb. 4, 2009). This corporate Advanced Notice of Proposed Rulemaking (ANPR) sought comment on how best to define and structure the role of corporates in the credit union system, whether to modify the level of required capital for corporates, whether to modify or limit the range of permissible investments for corporates, whether to impose new standards and limits on asset-liability management (ALM) and credit risk, and whether to make modifications in the area of corporate governance. NCUA received some 445 comments in response to the ANPR. NCUA reviewed these public comments closely and considered them carefully.

On November 19, 2009, the NCUA Board issued a Notice of Proposed Rulemaking (NPR) containing extensive, specific proposed revisions to NCUA's rule governing corporate credit unions (corporates) and related rule provisions. 74 FR 65210 (Dec. 9, 2009). The proposed revisions covered corporate capital, prompt corrective action (PCA), investments, ALM, CUSOs, and governance. Briefly summarized, the major provisions in the proposal would have:

- Imposed new minimum capital ratios, new risk based capital calculations, and new elements of capital, all in general accordance with the Basel I capital requirements imposed by the banking regulators on banks.
- Required that retained earnings (RE) constitute a certain portion of corporate capital, and that corporates build retained earnings over time.

- Eliminated the current prohibition on conditioning membership, the receipt of services, or the pricing of services upon the purchase of paid-in capital.
- Added new PCA provisions similar to those currently applicable to banks.
- Prohibited investments in collateralized debt obligations (CDOs) and net interest margin (NIM) securities.
- Toughened the capital requirements for expanded investment authority, and restricted the credit ratings for investments purchased by such corporates to a minimum of "A-."
- Required that a corporate examine every available Nationally Recognized Statistical Rating Organization (NRSRO) rating for a particular security and only employ the lowest of those ratings, and that at least 90 percent of a corporate's investments be rated by at least two NRSROs.
- Tightened the existing single obligor concentration limit and imposed new sector concentration limits.
- Placed limits on subordinated positions in structured securities.
- Imposed new limits on the maximum difference between the estimated average life of the asset cash flows and the average life of the liability cash.
- Restricted the weighted average life (WAL) of a corporate's cash-flowing assets to two years.
- Limited a corporate's aggregate borrowing to the lesser of 10 times capital or 50 percent of shares and capital; and further restrict secured borrowing to maximum maturities of 30 days and only for liquidity purposes.
- Prohibited a corporate from accepting investments or loans from any one entity that exceed ten percent of the corporate's assets.
- Required that a corporate CUSO only engage in categories of services preapproved by NCUA, including, initially, brokerage and investment advisory services.
- Required that a corporate CUSO agree with the corporate by contract to permit NCUA access to the CUSO's books, records, personnel, equipment, and facilities.
- Required that all corporate board members hold either a CEO, CFO, or COO position at a member credit union or other member entity.
- Generally limited corporate board members to no more than six years of service.
- Required that a majority of a corporate's board members be representatives of natural person credit unions (NPCUs).
- Required that each corporate annually disclose to its members the compensation of each senior executive officer and director.
- Required a merging federally-chartered corporate affirmatively disclose to both NCUA and its members any material, merger-related increase in compensation for any senior executive or director.

- Prohibited parties affiliated with a corporate from receiving 1) indemnification in connection with administrative or civil proceedings instituted by NCUA or a state regulatory authority where the party is ultimately found liable and 2) golden parachute payments.

The preamble to the NPR included an extensive discussion of the crisis in the corporates giving rise to the need for regulatory reform, followed by a discussion of the nature of, and justification for, each proposed revision. *Id.* at 65211 – 65255.

The public comment period for the NPR closed on March 9, 2010. NCUA received 815 public, written comments letters totaling more than 2,600 pages of comments. In addition, NCUA held several town halls and webinars during the comment period during which NCUA both answered questions about the proposed rulemaking and listened to oral comments about the proposal.

Most commenters liked some portions of the proposed rule and disliked other portions. The most common comment on the overall rulemaking was support for the proposed stronger capital requirements; increased limits on single obligors; concentration limits on certain investment sectors; and prohibitions on certain high risk securities -- but also serious reservations about other portions of the proposal, including certain ALM, investment, CUSO, and corporate governance provisions.

Of those commenters who expressed a general opinion on the overall rulemaking, many, including some trade groups and various larger NPCUs (i.e., over \$1.2 billion in assets), generally support the rule. Many more commenters, however, generally oppose the proposed rule, among them many small and medium-sized NPCUs ranging up to over \$1 billion in assets. Many of the commenters in opposition believed that the various investment and ALM restrictions in the proposed rule would cause major changes in corporate operations; that these changes would threaten the ability of corporates to provide liquidity and other valuable services to NPCUs; and that these changes might force NPCUs to turn to banks (their competitors) for services -- considered by the commenters as a more expensive and less reliable alternative to today's corporate system. The comments that pertain to specific, proposed revisions are discussed in more detail in the section-by-section analysis below.

The NCUA Board has now determined to issue final revisions based on the proposal and the comments received. Generally, these revisions will become effective 90 days following the publication in the Federal Register, but the effective date for many of the revisions will be delayed beyond 90 days.

The remainder of this preamble contains four sections: a summary of the significant revisions in the final rule, a section-by-section analysis of all the revisions, an analysis of how the final investment, credit risk, and asset liability provisions might affect a corporate's ability to achieve its capital requirements, and a discussion of the regulatory procedures affecting this rulemaking.

## **II. Summary of Significant, Final Revisions.**

### **A. Overview**

Ultimately, the primary purposes of this extensive rulemaking were twofold. First, NCUA wanted to design a corporate rule that would prevent the catastrophic losses that occurred in the corporate system beginning in 2007 from ever recurring. Second, NCUA wanted to allow for the survival of some form of a well-run corporate system that could provide necessary services, including payments systems services, to its members, and build and attract sufficient capital.

The Board believes this final rule accomplishes these two purposes.

First, and as discussed in more detail below, the 2007 losses resulted almost entirely from private label residential mortgage backed securities (RMBS), with many of the worst performing of these securities being subordinated RMBS. The final rule prohibits corporates from purchasing either private label RMBS, or subordinated-type securities, going forward. In the most specific sense, then, the rule will make it *impossible* for corporates to repeat what happened in 2007. Of course, the next financial crisis may not be a credit or mortgage crisis, so the final rule includes a series of other investment, credit risk, ALM, liquidity, and capital measures that together should greatly reduce the systemic risk posed by the corporates regardless of the source of the next crisis.

Second, the Board believes that a well-run corporate should be able to operate within the confines of the new rule and construct a business model, and an investment portfolio, that permits it to attract capital and grow retained earnings going forward. Again, this is discussed and demonstrated in some detail in Section IV. of the preamble below.

*Affected sections of NCUA's rules and regulations.*

The final revisions affect part 704, Corporate Credit Unions, and several other sections of NCUA's regulations. The following chart lists the affected sections. It also summarizes the effective dates for each section and, in some cases, the effective dates for particular paragraphs or individual definitions.

<b>Current Rule Provision</b>	<b>Amended?</b>	<b>Delayed Effective Date? (e.g., "+12 months" means delayed 12 months following date of publication of final rule in Federal Register)</b>
704.1 <u>Scope</u>	No.	Not applicable (N/A)
704.2 <u>Definitions</u>	Yes. Removed and replaced twice. Second replacement introduces capital and PCA definitions.	First replacement of 704.2. +90 days Second replacement of 704.2. +12 months <u>Adjusted core capital</u> -- deduct PCC or NCA at another corporate. +12 months -- deduct certain excess PCC. +72 months to +120 months -- deduct PCC in excess of retained earnings. +120 months <u>Permanent leverage ratio.</u> +36 months
704.3 <u>Corporate credit union capital</u>	Yes.	Current 704.3 replaced. +12 months 704.3(a)(3): If RE ratio less than 0.45, must submit REAP. +36 months 704.3(f)(4): Corporate with unconverted MCAs must notify MCA holders of account status. +14 months
704.4 <u>Board responsibilities</u>	Yes. The current <u>Board responsibilities</u> is redesignated as 704.13. New 704.4 <u>Prompt corrective action</u> (PCA) added.	Current 704.4 replaced with PCA section. +12 months
704.5 <u>Investments</u>	Yes.	+90 days
704.6 <u>Credit risk management</u>	Yes.	+90 days
704.7	No.	N/A

<b>Current Rule Provision</b>	<b>Amended?</b>	<b>Delayed Effective Date? (e.g., “+12 months” means delayed 12 months following date of publication of final rule in Federal Register)</b>
<u>Lending</u>		
704.8 <u>Asset and liability Management</u>	Yes.	Generally, +90 days 704.8(k): Prohibition on a corporate receiving more than 15 percent of business from one member or credit union. +30 months
704.9 <u>Liquidity management</u>	Yes.	+90 days
704.10 <u>Investment action plan</u>	No.	N/A
704.11 <u>Corporate CUSOs</u>	Yes.	Generally, +90 days 704.11(e)(1): Requirement for NCUA approval of corporate CUSO activities. +180 days. 704.11(e)(2): Requirement that corporate divest from CUSO engaged in unapproved activities. +12 months
704.12 <u>Permissible services</u>	No.	N/A
704.13 [Reserved]	Yes.	The current 704.4 <u>Board responsibilities</u> redesignated as 704.13. +90 days.
704.14 <u>Representation</u>	Yes.	Generally, +90 days. 704.14(a)(2): Requirement that only CEO, CFO, or COO may seek election to corporate board. +120 days 704.14(a)(9): Requirement that at least a majority of each corporate’s directors be representatives of NPCUs. +36 months
704.15 <u>Audit requirements</u>	No.	N/A
704.16 <u>Contract/written agreements</u>	No.	N/A
704.17	No.	N/A

<b>Current Rule Provision</b>	<b>Amended?</b>	<b>Delayed Effective Date? (e.g., “+12 months” means delayed 12 months following date of publication of final rule in Federal Register)</b>
<u>State-chartered corporate credit unions</u>		
704.18 <u>Fidelity bond coverage</u>	No.	N/A
704.19 <u>Wholesale corporate credit unions</u>	Yes.	Current 704.19 removed, and new 704.19, <u>Disclosure of executive and director compensation</u> , added. +90 days.
704.20 None.	Yes.	New 704.20, <u>Golden parachute and indemnification payments</u> , added. +90 days.
Appendix A <u>Model Forms</u>	Yes.	Amended and renamed <u>Capital Prioritization and Model Forms</u> . +90 days. Appdx A, Part I: Corporates may determine that newly contributed capital has priority over existing capital. +90 days
Appendix B <u>Expanded Authorities and Requirements</u>	Yes.	Generally, +90 days Part I(e): Substitute “leverage ratio” for “capital ratio.” +12 months
Appendix C None.	Yes.	New Appendix C, <u>Risk-Based Capital Credit Risk-Weight Categories</u> , added. +12 months
702.105	Yes.	Conforming amendment (to substitute new capital terms). +12 months
703.14(b)	Yes.	Conforming amendment (to substitute new capital terms). +12 months
709.5(b)	Yes.	Conforming amendment (to substitute new capital terms). +90 days
Part 747, subpart M	Yes.	Add new subpart M on due process for PCA actions. +12 months

Third Party Evaluation of Proposed Rulemaking

NCUA commissioned an outside consultant, Kamakura, Inc., to provide NCUA with an assessment of the proposed corporate rule. Kamakura issued its final report, entitled *Impact Analysis – Proposed Modification of 12 Code of Federal Regulations Part 704 – National Credit Union Administration* (the “Kamakura Report”), on July 12, 2010. Interested parties can download a copy of the Kamakura Report from NCUA’s website at [www.ncua.gov](http://www.ncua.gov). As discussed throughout the following preamble, NCUA carefully considered the Kamakura Report when finalizing the investment and ALM provisions of this rulemaking.

### Legacy assets

The ability of some corporates to comply with the provisions of this final rule depends on managing certain “legacy assets” on their balance sheet. These legacy assets are securities, generally private label RMBS, that continue to carry significant credit risk and market values far below their intrinsic values.

NCUA has been working for some time on a plan to isolate such legacy assets in those corporates where the exposure represents the greatest risk to the insurance fund. In general, these cases represent corporate credit unions where expected future credit losses exceed the corporate’s total capital, and recapitalization would not occur without agency assistance. NCUA has, as promised, released its plans for dealing with those corporates’ legacy assets. Information about the plans can be obtained from NCUA’s website at [www.ncua.gov](http://www.ncua.gov).

Some corporates have lesser positions in RMBS assets where NCUA does not expect the associated credit losses to exceed the corporate’s total capital. They may also have other assets with long WALs, positions that are concentrated beyond the prescribed diversification limits, or other portfolios that otherwise inhibit compliance with new rule. NCUA expects these institutions to develop business plans and take action to become compliant with the rule. Generally, NCUA will want these corporates to sell these legacy assets as soon as possible so as to come into compliance with the corporate rule. If the corporate decides an alternative approach to selling the legacy assets is sound and supportable, the corporate will have to submit a draft investment action plan to NCUA for its approval under §704.10 and other provisions of the corporate rule, such as §704.8(j)(2)(i). For example, NCUA will consider approval of an action plan that includes retention of these legacy assets while they amortize if the corporate can document that the expected future credit losses on these assets are significantly less than the losses the corporate would take if the investments were sold at current market prices. Depending on the circumstances of the corporate, an NCUA-approved action plan might permit the corporate to operate temporarily outside the WAL limitations and other applicable investment, credit risk, or ALM limitations in the corporate rule. In addition, NCUA might grant these corporates a waiver of time to build the retained earnings required by this regulation -- but

only to the extent of documented losses flowing from legacy assets identified in an approved action plan. 12 CFR 704.1(b).

*Effect of the Dodd-Frank Act on the use of credit ratings.*

Just recently, on July 21, 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). The DFA, which contains 848 pages divided into 16 separate Titles, has multiple impacts on NCUA, its regulations, and its enforcement authority. The Board is carefully considering the implications of the DFA and the actions NCUA is required to take under the DFA.

One section of the DFA that is likely to affect NCUA's regulations, including the corporate credit union regulation, reads as follows:

**SEC. 939A. REVIEW OF RELIANCE ON RATINGS.**

(a) AGENCY REVIEW.—Not later than 1 year after the date of the enactment of this subtitle, each Federal agency shall, to the extent applicable, review—

(1) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and

(2) any references to or requirements in such regulations regarding credit ratings.

(b) MODIFICATIONS REQUIRED.—Each such agency shall modify any such regulations identified by the review conducted under subsection (a) to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations. In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness.

(c) REPORT.—Upon conclusion of the review required under subsection (a), each Federal agency shall transmit a report to Congress containing a description of any modification of any regulation such agency made pursuant to subsection (b).

DFA, §939A. Both NCUA's current and revised corporate rules include references to NRSRO credit ratings. As stated in §939A, NCUA has one year to review all its regulations and modify them to remove such references and "substitute in such regulations such standard of credit-worthiness as [the Board]

shall determine to be appropriate.” Until the Board completes that review and modification, however, corporates will be expected to comply with all the provisions of the corporate rule that make reference to NRSRO ratings.

The Dodd Frank Act also affected the definition of small business related securities in §704.2. The current definition reads as follows:

Small business related security means a security as defined in Section 3(a)(53) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(53)), e.g., a security that is rated in 1 of the 4 highest rating categories by at least one nationally recognized statistical rating organization, and represents an interest in one or more promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution, insured credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or a finance company or leasing company. This definition does not include Small Business Administration securities permissible under §107(7) of the Act.

Section 939(e)(2) the DFA, however, eliminates the reference to NRSRO ratings in Section 3(a)(53), and substitutes a reference to “meets standards of credit-worthiness established by the [Securities and Exchange] Commission (SEC).” Again, until such time as either the SEC or NCUA can provide some content to the latter phrase, NCUA believes that the definition of small business related security in §704.2 should remain unchanged.

## **B. Capital.**

### Summary of current capital provisions.

Currently, corporates have only one mandatory minimum capital requirement: they must maintain total capital (i.e., retained earnings (RE), paid-in capital, and membership capital accounts) in an amount equal to or greater than 4 percent of their moving daily average net assets.<sup>1</sup> Failure by a corporate to meet this minimum capital ratio triggers the requirement to file a capital restoration plan with NCUA and may cause NCUA to issue a capital restoration directive and take other administrative action.

The current rule allows a corporate to issue Paid in Capital (PIC) to both members and nonmembers, while Membership Capital Accounts (MCAs) may only be issued to members. The current rule also prohibits a corporate from

---

<sup>1</sup> Corporates have other capital-related requirements, such as a core capital ratio and a retained earnings ratio, but failure to meet these requirements only triggers future earnings retention requirements and does not trigger a capital restoration plan requirement or other particular supervisory actions.

conditioning membership, the receipt of services, or the pricing of services upon the purchase of PIC.

Summary of proposed capital revisions (November 2009).

The proposal contains a capital scheme based on the Basel I capital regimes of the other banking regulators. The proposal renames PIC as Perpetual Contributed Capital (PCC), and makes certain changes to the MCA requirements and labels those MCAs as Nonperpetual Capital Accounts (NCAs). The proposal then seeks to replace the one existing total capital ratio with three minimum capital ratios, including two Risk Based Capital (RBC) ratios. These RBC ratio calculations involve credit risk- weighting the corporate's assets and off balance sheets activities to produce a moving daily average net risk-weighted assets (MDANRA).

The three new proposed ratios are described in the following chart:

Ratio:	Numerator <sup>2</sup>	Denominator	Minimum level (Adequate Cap.)	Minimum level (Well Cap.)
Leverage Ratio	RE + PCC	MDANA	4%	5%
Tier-One RBC Ratio	RE + PCC	MDANRA	4%	6%
Total RBC Ratio	RE + PCC + NCAs	MDANRA	8%	10%

The proposal also requires that, in the leverage ratio and Tier 1 RBC ratio, the corporate may only count PCC to the extent that it does not exceed the corporate's RE. That results in the corporate needing 200 basis points (BP) of RE to reach a 4 percent leverage ratio and so be adequately capitalized, and 250 BP to be well-capitalized. This RE requirement, and the various other proposed capital measures, are phased-in over a ten-year time period, as discussed below.

Summary of proposed phase-in of capital provisions.

---

<sup>2</sup> These numerator formulas are simplifications. The proposal actually contains certain adjustments to each capital calculation, and those proposed adjustments that received comments are discussed below.

The proposal contains a multi-step, multi-year phase-in of the new capital requirements:

- *Year one.* None of the new capital requirements would apply during the first year following publication of the final rule. During this period the current total capital ratio would remain in effect, as well as the revised capital order, and associated waivers, issued by the NCUA Board on April 29, 2010.<sup>3</sup>
- *Years two and three.* The two new risk based capital ratios would come into effect on the first anniversary of the publication of the final rule. Corporates would be required to meet a minimum 4 percent Tier 1 RBC ratio and a minimum 8 percent Total RBC ratio. In addition, corporates would be required to satisfy an interim leverage ratio, defined almost identically to the existing total capital ratio. Because NCUA should have resolved the legacy assets at this point, *and* most corporates will have very low-risk weighted assets, neither of the two RBC ratios will likely dictate the amount of capital corporates need at this point. Instead, actual minimum capital requirement will likely be dictated by the interim leverage ratio, meaning a corporate will need 200 BP in PCC/RE and another 200 BP in NCAs.
- *Years four through six.* At the third anniversary of the publication of the final rule, the 4 percent minimum leverage ratio goes into effect. In addition, any corporate that does not have at least 45 BP of RE on the third anniversary must file a retained earnings action plan (REAP) with the NCUA illustrating how it is going to achieve the upcoming RE requirements at the sixth and tenth anniversaries of the final rule.
- *Years seven through ten.* At the sixth anniversary of the publication of the final rule, a corporate must have at least 100 BP of RE to be considered adequately capitalized.
- *Year eleven and after.* At the tenth anniversary of the publication of the final rule, a corporate must have at least 200 BP of RE to be considered adequately capitalized.

---

<sup>3</sup> The Net Economic Value (NEV) limitations that exist in the current rule have not changed under this final rule. 12 CFR 704.8(d). Thus, these NEV limits continue to be in effect and no implementation delay for these NEV limits is warranted.

Overview of significant capital revisions in this final rule.

Most of the public comments on the capital provisions, including comments received from corporate credit unions, were supportive of the new proposed Basel I capital requirements, including the use of risk-based capital measures.

Some of these commenters specifically supported the use of Basel I standards over Basel II, stating that Basel I was adequate and less complex.

The Board agrees with these commenters, and has generally adopted, with some modifications, the minimum capital ratios, risk based capital calculations, and new elements of capital, as set forth in the proposed rule. As in the proposed, the final revisions will require that RE constitute a certain portion of capital. For example, to be adequately capitalized, a corporate must have at least 100 BP of RE after six years, and 200 BP of RE after ten years. Other elements of the new capital provisions will also be phased in over time, beginning one year after publication of this final rulemaking. The final revisions eliminate the current prohibition on conditioning membership, services, or the pricing of services upon the purchase of paid-in capital. Details about each final revision are contained in the section-by-section analysis below.

Some commenters, including NPCUs, questioned whether corporates need any capital. Other commenters stated that NCUA should not require any contributed capital, and that corporates should be given sufficient time to “earn” their way to adequate capitalization.

The Board is concerned that NCUA’s extraordinary actions to stabilize and protect the corporate system over the past few years have been misunderstood by some of these commenters. Because of NCUA’s actions, including the Temporary Corporate Credit Union Share Guarantee Program (TCCUSGP) and the Temporary Corporate Credit Union Liquidity Guarantee Program (TCCULGP), many corporates have been able to operate as going concerns with artificially low levels of capital. Measures like the TCCUSGP and TCCULGP are, however, temporary measures. In the future, NCUA will wind down and terminate these measures, and corporates will have to function on their own. Further, corporates and their members cannot expect to ever again receive such extraordinary government support, either explicitly or implicitly, from NCUA or

any other government entity.<sup>4</sup> In fact, it is NCUA's intention with the various revisions in this final rule to ensure that the corporates, going forward, never again present the sort of systemic risk to the entire credit union system that requires such extraordinary intervention. And this means that, without building adequate capital going forward, corporates will not be able to function.

Inadequate levels of capital introduce unacceptable moral hazards. When the owners of an entity have significant amounts of their own capital at stake, they have incentive to ensure that the entity is prudently operated and does not engage in overly risky activity, because the risk of loss is born by the capital owners. However, when the owners have little or no capital at stake, they have the incentive to overlook, or even encourage, risky behavior by the entities' management. We observed some of this risky behavior at certain corporates in the recent past – and this behavior was likely fueled by contributed capital levels that were too low for the risks undertaken, as well as the fact that some member owners of these corporates did not fully understand the nature and extent of their potential capital losses and so were not actively engaged in the oversight of their corporates. NCUA will not permit corporates to operate with low capital levels that encourage risky behavior. Accordingly, NCUA intends with this rulemaking to ensure corporates have adequate capital levels going forward to mitigate such moral hazard.<sup>5</sup>

In addition to introducing unacceptable moral hazards, low capital levels have negative, direct effects on an entity's ability to function. For example, potential creditors would not likely lend to any corporate that does not have capital sufficient to absorb losses, because the creditors will have legitimate fears that any operating losses in the corporate will keep the creditors from getting repaid. Likewise, potential third-party vendors would not do business with corporates that do not have capital available to absorb operating losses, because these vendors would be afraid that any losses would have negative effects on the corporate's ability to pay the vendors' invoices.<sup>6</sup>

In sum, going forward corporates must survive on their own and without continued government assistance – and that means corporates must have their own adequate capital.

---

<sup>4</sup> Except, of course, for the standard federal share insurance of up to \$250,000, as mandated by the Federal Credit Union Act.

<sup>5</sup> The Board also believes that all NPCUs now understand the nature of any capital commitment to a corporate and the need to be involved in the direction and management of their corporates.

<sup>6</sup> As indicated above, after the TCCUSGP and the TCCULGP have served their purposes and been terminated NCUA will no longer provide corporates with extraordinary support. NCUA will disabuse the public, the members, any potential creditors of a corporate, and any potential vendors of a corporate, of the idea that NCUA will again intervene to protect insolvent corporates.

In response to the other comments, NCUA is not requiring that any of a corporate's capital be contributed capital. NCUA will not, however, continue its extraordinary support of the corporate system over the time it would take to build sufficient capital just through RE growth alone. For example, to achieve a 4 percent capital ratio just through RE growth could take 20 years or longer. It is inappropriate for the NCUA, which is a government entity, to provide the necessary guarantees and other assistance that would enable a corporate to survive that long with such low levels of capital. And that means that, to survive as a going concern without continued government assistance, a corporate must solicit and achieve sufficient capital in the form of contributed capital. Any corporate that is unable to obtain the requisite levels of capital in a timely manner may have to be liquidated or merged.

Some commenters questioned the need for any minimum RE requirement. One corporate stated that, from a NCUSIF standpoint, contributed capital acts in the same capacity as RE. This commenter believes that the building of RE is typically a decision made by the organization's Board and so does not believe that the portion of capital that is RE should be designated within the regulation. Another corporate commenter, however, recognized the need for a minimum RE requirement.

As discussed at length in the preamble to the proposed rule, NCUA believes that, eventually, some part of a corporate's capital must consist of RE. This is the only form of corporate capital that, when depleted, does not result in losses that flow downstream to NPCUs. Without some RE, the corporates would be a continued source of instability to the credit union system as a whole.

A few commenters stated that NCUA needed to look at other sources besides credit unions to recapitalize the corporate system, without specifying which sources. The Board is unaware of any other logical sources of capital. Corporates are member-owned cooperatives established to serve their member NPCUs, so logically the primary source of a corporate's contributed capital should be its member-owner NPCUs. Still, corporates have always been free to sell paid-in capital to nonmembers, including non-credit union nonmembers, but to date have been either unwilling or unable to do so. The proposal, and these final revisions, permit corporates to sell all forms of contributed capital, including nonperpetual capital, to nonmembers at the corporate's discretion. To the extent, however, that some commenters might believe that NCUA or the federal government can donate capital to corporates, that is neither legally possible nor a good idea as a policy matter. As stated above, credit unions in general, and corporates in particular, cannot depend on continued government assistance to survive.

Some commenters thought the proposed capital requirements were overly complex. The NCUA Board disagrees. Corporates are complex financial entities and so require some detail and nuance in their regulation. The Board notes that the Basel I standards, and associated regulations, are no more complex than those capital standards imposed on banking entities with similarly complex operations and activities.

A few commenters that generally opposed the new capital standards stated that the NCUA's basic rationale for the proposed changes is that the permanence of capital and a risk-based capital standard would have mitigated the losses at Corporates in the past two years. This is not a correct statement. NCUA has long been considering amendments to improve corporate capital standards, even before the credit crisis of 2007. The new capital standards, as proposed and finalized here, are intended to help protect the corporates, their members, and the NCUSIF from future losses, whether or not those future losses are related to credit risk in the mortgage markets (as in 2007) or are caused by other factors.

A few commenters questioned why NCUA was imposing capital requirements on corporates that were similar to banking capital requirements while at the same time imposing ALM and investment requirements that were different from those imposed on banks. The Board believes that while many corporates engage in activities and take on risks similar to banks, and thus should have a capital regime similar to banks, the risks that corporates pose to NPCUs are systemic risks, and thus different than the risks posed by one bank to another bank. It is true that a few very large banks may present systemic risks to the banking system, but the Basel I standards contained in this rulemaking are different than the Basel II advanced standards that very large banks are subject to.

Several NPCU commenters were concerned that the likelihood of ongoing corporate consolidation, combined with factors in the proposal such as the lengthening of the MCA three year requirement to five years and the requisite NCUA approval for any return of PCC, all increased the possibility that an NPCU might find itself stuck with significant capital in a corporate to which that NPCU did not want to belong. Natural person credit unions will have to decide, going forward, what services they want from corporates. As part of that decision, they will have to decide if they are willing to contribute capital to one or more corporates. If they decide to contribute capital, they will have to take into account the possibility that the corporate may then consolidate or merge with another corporate. If that should happen, and the NPCU no longer desires services from the continuing corporate, the NPCU does have several options. First, it may ask the corporate to redeem the capital. If such redemption complies with NCUA's regulations, and NCUA approves the redemption, the corporate may redeem the capital. Second, the member NPCU can attempt to transfer (sell) the capital to

another member. And, third, the member NPCU can attempt to transfer the capital to a nonmember.

A few commenters believe the proposed capital phase-in period is appropriate, and one NPCU labeled it as generous. Many commenters, however, believe that the proposal provides too short a time period for the phase-in of the proposed new capital requirements.

The Board believes that the final capital phase-in, which mirrors the proposed phase-in, is both appropriate and feasible. As discussed in the preamble to the proposed rule, the phase-in period balances the need for corporates to 1) quickly achieve sufficient capital, and wean themselves from government assistance, through solicitations of contributed capital and growth of RE, while 2) providing for an adequate opportunity to make that solicitation and achieve that growth.

The proposed rule was issued ten months ago, and corporates have had some time since then to consider the ramifications of the proposal. Further, none of the new capital provisions will be effective until the first anniversary of the publication of this final rulemaking in the *Federal Register*. This one year period gives corporates ample opportunity to analyze the elements of this final rule, perfect their business plans, convince their members of the validity of their business plans, and solicit contributed capital.<sup>7</sup> Corporates that are well-run should be able to make an effective solicitation so as to garner sufficient contributed capital by the first anniversary.

Under the final rule, the first specific RE target (e.g. 45 BP of accumulated RE) does not go into effect until the third anniversary of publication, and the first specific RE requirement (100 BP) does not go into effect until the sixth anniversary of publication. As discussed in the sections below on the asset liability management provisions of the final rule, the final investment and ALM provisions permit corporate credit unions a bit more leeway in the mismatch of their assets and liability cash flows than in the proposed rule, and the Board believes this should help corporate credit unions generate additional earnings on their assets. As also discussed below, NCUA has modeled various investment portfolios that corporates could purchase under provisions of the final corporate rule, and the Board has concluded that a well-run corporate can, in fact, generate 45 BP of earnings in the first three years and 100 BP of earnings in the first six years as required by the capital phase-in.

Other, more specific comments on capital are discussed in the section-by-section analysis below.

### **C. Prompt Corrective Action (PCA).**

---

<sup>7</sup> Some corporates may not even need additional capital on the first anniversary.

Although prompt corrective action (PCA) applies to natural person credit unions (NPCUs) and to banking entities, PCA does not currently apply to corporates. The proposed rule contained a PCA regime similar to what the other banking regulators, and the Federal Deposit Insurance Act, impose on banks.

The final rule adopts the proposed PCA provisions substantially as proposed. Each corporate will be assigned to one of five capital categories: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The potential consequences of failing to meet capital standards include restrictions on activities, restrictions on investments and asset growth, restrictions on the payment of dividends, restrictions on executive compensation, requirements to elect new directors or dismiss management, and possible conservatorship. The final rule does include some due process enhancements beyond those contained in the proposed rule.

#### **D. Corporate investments, credit risk, and asset-liability management (ALM).**

##### *Summary of current investment, credit risk, and ALM provisions.*

The current Part 704 generally prohibits certain types of investments, including derivatives, stripped mortgage backed securities (MBS), mortgage servicing rights, and residual interests in asset backed securities (ABS). The rule specifies, for permissible investment types, that investments must be rated no lower than AA- by at least one NRSRO at time of purchase. Corporates that qualify for Part I expanded authority, however, have additional investment authority, including the purchase of investments rated down to A-. Corporates that qualify for Part II expanded authority may purchase investments rated down to BBB(flat). Corporates that qualify for Part III expanded authority may invest in certain foreign obligations; corporates that qualify for Part IV expanded authority may engage in derivatives transactions for certain specified purposes; and corporates with Part V expanded authority may engage in certain loan participations.

The current rule requires that corporates maintain an internal investment policy that includes “reasonable and supportable concentration limits” including limits by “investor type and sector.” The current rule limits the aggregate of all investments in any single obligor to the greater of 50 percent of capital or \$5 million, but includes no regulatory sector limits. The rule does not limit

investments that are structured to be subordinate, in terms of potential credit losses, to other securities.

*Summary of significant proposed investment, credit risk, and ALM provisions*

NCUA developed the proposed changes to the investment, credit risk, and ALM provisions based on lessons learned from both the recent experience with corporate investment portfolios and their associated losses and comments received from the ANPR.

NCUA determined that three major risk conditions were the primary contributors to the current losses in the corporate system: (1) excessive investment sector concentrations, particularly private label RMBS; (2) excessive average-life mismatches between assets and liabilities; and (3) excessive concentrations in subordinated securities, including mezzanine securities. The proposed revisions to the investment and asset-liability provisions of the corporate rule control these risk conditions in the aggregate through the use of limits, many of which are tied to a corporate credit union's capital. The proposal provided a framework that allowed for a level of risk-taking necessary to support the profitability of a corporate but which would also be continuously and adequately protected by the corporate's capital.

The proposed rule established new prohibitions for investments in collateralized debt obligations (CDOs) and net interest margin (NIM) securities.

The proposal also required that a corporate examine the NRSRO rating from every NRSRO that publicly rates a particular investment and only employ the lowest of those ratings and required that at least 90 percent of a corporate's investments be rated by at least two NRSROs. The proposal eliminated Part II expanded authority, thus making "A-" the lowest possible rating for an NRSRO-rated investment purchased by a corporate with expanded investment authority. To qualify for Parts I and II (i.e., the current Parts I and III) expanded investment authority, the proposal required a corporate achieve and maintain higher capital levels, that is, a minimum six percent capital ratio.

The proposal generally reduced the single obligor limits from 50 percent of capital to 25 percent of capital, with slightly higher limits for investments in mutual funds and repurchase agreements. The proposal also imposed specific concentration limits by investment sector. Sectors included residential mortgage backed securities (RMBS), commercial mortgage backed securities (CMBS),

student loan asset backed securities (ABS), automobile loan/lease asset backed securities, credit card asset backed securities, other asset backed securities, corporate debt obligations, municipal securities, and money market mutual funds, and an “all others” category to account for the development of new investment types. The proposed sector limits were, generally, 1) the lower of 500 percent of capital/25 percent of assets, or 2) the lower of 1000 percent of capital/50 percent of assets (for the less risky sectors).

The proposal excluded certain assets entirely from both the single obligor concentration limit in §704.6(b) and the sector concentration limits in §704.6(c). The excluded assets include fixed assets, loans, investments in CUSOs, investments issued by the United States or its agencies or its government sponsored enterprises, and investments fully guaranteed or insured as to principal and interest by the United States or its agencies. Investments in other federally-insured credit unions, deposits in other depository institutions, and investment repurchase agreements would also be excluded from the sector concentration limits but not the single obligor concentration limit. Investments in CUSOs, while excluded from both the §704.6 concentration limits, would still be subject to the investment limits in the corporate CUSO rule, §704.11(b).

The proposal limited subordinated positions in a structured security to the lesser of 100 percent of capital/5 percent of assets in any given sector class and the lesser of 400 percent of capital/20 percent of assets in the aggregate.

The proposal generally limited a corporate’s Part III (renumbered from Part IV) derivatives activity to derivatives used for the purposes of reducing the corporate’s overall risk.

*Summary of significant investment, credit risk, and ALM revisions from the proposed to the final rule.*

Based on comments received and further review, the NCUA Board adopted most of the proposed provisions but also made some significant changes. The most significant changes in the final rule were the removal of the two ALM provisions designed to limit cash flow mismatches between assets and liabilities. In place of these tests, the final rule substitutes an alternative weighted average life extension test on the corporate’s investments along with specific prohibitions on private label RMBS and subordinated securities.

The effect of these changes is to create the following, final set of investment, credit risk, and ALM hurdles through which a corporate must run any contemplated investment purchase:

- *NRSRO ratings screen.* The final rule uses NRSRO ratings as a screening tool. The final NRSRO screen is tougher than the current rule provides. For example, to get by the ratings screen the corporate has to look at all available NRSRO ratings (not just one rating), and the corporate has to take the lowest of all the ratings (i.e., it can't cherry pick ratings). This ratings screen is exclusionary, not inclusionary. Even if a security gets by the ratings screen, there are still six additional hurdles (listed below) each security must pass before the corporate can buy the security.
- *Prohibition of certain highly complex and leveraged securities.* NCUA is adding to the list of outright prohibited securities in part 704 that are overly complex and/or leveraged. So a corporate cannot buy the security if it is:
  - A Collateralized debt obligation (CDO), or
  - A Net Interest Margin security (NIM), or
  - A Private label RMBS, or
  - A security subordinated to any other securities in the issuance.
- *Single obligor limit.* The final rule tightens the existing limit from 50% of capital to 25% of capital. So if the corporate wanted to buy, say, a highly rated student loan asset backed security (ABS) issued by "Mainstreet Bank", but the corporate has already reached the 25% of capital limit in investments issued by the same Mainstreet Bank trust, the corporate can't buy that additional ABS within the same trust.
- *Sector concentration limits.* Assuming the corporate still wants to buy that Mainstreet Bank ABS, and it has not reached its single obligor limit with Mainstreet Bank, the corporate must then apply the sector limits for these ABS. If the purchase of the Mainstreet Bank ABS would put the corporate over the private label student loan ABS sector limit (generally, the lower of 500% of capital or 25% of assets), the corporate can't buy the ABS.
- *Portfolio WAL not to exceed two years.* If the corporate got the Mainstreet Bank ABS past all those hurdles above, there are still more hurdles to overcome. The corporate cannot buy the ABS if it would put the weighted average life (WAL) of the corporate's loan and investment portfolio over two years in length.

- *Portfolio WAL (assuming prepayment slowdown of 50%) not to exceed 2.25 years.* The corporate must then test the Mainstreet Bank ABS for extension risk. The corporate cannot buy the ABS if it would put the weighted average life of the corporate's loan and investment portfolio, assuming the portfolio prepayment speeds slow by 50%, out over 2.25 years in length.
- *Interest rate risk shock test.* This IRR test is in the current rule, and the final rule does not change this test. Assuming that the Mainstreet Bank ABS is floating rate, and its liabilities reset rates in similar fashion, it would likely not be affected at all by this particular test. But if its liabilities did not reprice similarly to the ABS (e.g., the floating rate ABS was funded by fixed rate liabilities), its addition to the portfolio could not cause the corporate's NEV to decline by more than 15 percent when the portfolio as a whole is shocked by 300 BP.<sup>8</sup>

These final revisions provide for a simpler rule that still accomplishes NCUA's goal of reducing or eliminating various risks while allowing for sufficient potential for growth in a corporate's RE.

*Investment action plans for prohibited investments.*

Most of the new investment prohibitions and other credit and ALM requirements go into effect 90 days after publication of the final rule. Some corporates may hold investments that are in violation of one or more of these new prohibitions, and these investments will be subject to the investment action plan provisions of §704.10. For example, if a corporate holds a subordinated security prohibited by the revised paragraph 704.5(h)(8), and determines not to sell that security, it must, within 30 calendar days of the effective date of the 704.5(h)(8) prohibition prepare and submit to the OCCU Director an investment action plan. 12 CFR 704.10(a). If the plan is not approved by the OCCU Director, the corporate must comply with the "Director's directed course of action." 12 CFR 704.10(c).

## **E. Liquidity**

*Summary of current rule.*

The current rule generally requires a corporate evaluate its liquidity needs and plan for appropriate liquidity. It also provides that a corporate credit union may

---

<sup>8</sup> Assuming the corporate was operating under Base level investment authority.

borrow up to the greater of 10 times capital or 50 percent of capital and shares (excluding shares created by the use of member reverse repurchase agreements).

Summary of significant revisions.

The proposal restricted a corporate's borrowing to the lower of 10 times capital or 50 percent of capital and shares (excluding shares created by the use of member reverse repurchase agreements). The proposal also added a sublimit for secured borrowings. The final rule adopts the proposal without changes.

**F. Corporate governance provisions.**

Summary of current rule.

The current Part 704 places limitations on board representation, including limits on the number of trade organization representatives. The current rule does not, however, place any experience or knowledge requirements on individual corporate directors; limit the representation of corporate managers and officials on the boards of other corporates; provide for term limits; require any disclosure of senior executive compensation to the members of a corporate; or place any limits on "golden parachute" severance packages for corporate senior executives.

Summary of significant governance revisions.

The final revisions require that all corporate board members hold either a CEO, CFO, or COO position at their member credit union or other member entity. The final rule will, for clarity, add the positions of Manager and Treasurer, as these are often the equivalent of CEO or CFO at smaller credit unions. The revisions also require that a majority of a corporate's board members be representatives of NPCU members. The proposal also included a six year term limit on board service, but this mandatory term limit has been removed from the final rule.

The final revisions require that each corporate annually prepare, and provide to its members, a document that discloses the compensation of certain employees. For corporates with 41 or more employees, the disclosure must include the top five compensated employees. For corporate with 31 to 40 employees, the

disclosure must include the top four compensated employees. For corporates with 30 or fewer employees, the disclosure must include the top three compensated employees.

With respect to any corporate merger, the final revisions require a merging federally-chartered corporate affirmatively disclose to both NCUA and its members any material, merger-related increase in compensation (i.e., an increase of more than 15 percent of annual compensation or \$10,000, whichever is greater) for any senior executive or director. A state-chartered corporate must also make the merger-related disclosure, but only to NCUA unless state law requires otherwise.

The final revisions prohibit golden parachutes, that is, payments made to an institution affiliated party (IAP) that are contingent on the termination of that person's employment and received when the corporate making the payment is either troubled, undercapitalized, or insolvent. The revisions also generally prohibit a corporate, regardless of its financial condition, from paying or reimbursing an IAP's legal and other professional expenses incurred in administrative or civil proceedings instituted by NCUA or a state regulatory authority where the IAP is ultimately found liable.

## **G. Corporate CUSOs.**

### Summary of current rule.

The current corporate CUSO provisions do not specify the particular services that corporate CUSOs may offer, but does provide that the CUSO must “primarily serve credit unions” and “restrict its services to those related to the normal course of business of credit unions.” The current rule requires the CUSO agree to allow the corporate’s auditor, the corporate’s board, and also NCUA access to the CUSO’s “books, records, and any other pertinent documentation.”

### Summary of significant CUSO revisions.

The final revisions will retain the existing 704.11 requirements, and further require that a corporate CUSO may only engage in categories of services preapproved by NCUA. Brokerage services and investment advisory services will be preapproved in the rule, and NCUA will approve additional categories of services on an *ad hoc* basis. Once approved, however, NCUA may only remove

a category of service through a rulemaking. The final rule provides extra time for a CUSO to seek NCUA approval of a service category, and extra time for a corporate to extricate itself from a CUSO that is engaged in activities not preapproved by NCUA.

The final revisions further require a CUSO agree to permit the corporate and NCUA to access the books, records, personnel, equipment, and facilities of the CUSO.

#### **B. Delay of effective dates.**

None of these final revisions will take effect until 90 days following publication of this final rulemaking in the *Federal Register*. This delay in the effective dates will generally provide the corporates, and their NPCU members, some time to analyze and adapt to the final rule and to observe how NCUA is moving forward on resolution of the legacy asset problem.

Some provisions of this final rule, including the capital and PCA provisions, will have delays in their effective dates that are much longer than 90 days. Those delays will be discussed below.

### **III. Section-by-Section Analysis.**

This section, which provides a section-by-section analysis of the final revisions, generally follows the organization of part 704, that is, starting with the proposed capital (§704.3) and PCA (§704.4) amendments, then investments (§704.5) and credit risk (§704.6), then asset and liability management (§704.8), then corporate board representation §(704.14), and then the new sections relating to disclosure of executive and director compensation (§704.19) and golden parachutes and indemnification (§704.20).

Many of the final revisions require new definitions that appear in §704.2, and the discussion of these definitions generally appears with the discussion of the associated substantive change to the corporate rule. This rulemaking revises Appendices A and B, and adds a new Appendix C. Since Appendix B relates to investment authority, the revisions to that appendix are discussed as part of the discussion of §704.5. Since Appendices A and C (on model forms and the risk-

weighting of assets, respectively) relate to corporate capital, the changes to these appendices are discussed immediately following the discussion of §704.3. The new subpart L to part 747 provides the due process associated with the new PCA provisions in §704.4, and so is discussed following the §704.4 discussion.

The revisions to capital terminology in part 704 also necessitate conforming amendments to parts 702, 703, and 709, as discussed below.

## **A. PART 702 PROMPT CORRECTIVE ACTION**

Part 702 sets forth PCA for NPCUs. The proposal contained a conforming amendment to paragraph 702.105(d) changing references to paid-in capital and membership capital to perpetual capital and nonperpetual capital accounts, respectively. The final 702.105(d) is adopted as proposed.

## **B. PART 703 INVESTMENTS AND DEPOSIT ACTIVITIES**

Part 703 sets forth the permissible investment and deposit activities generally applicable to federal credit unions. The proposal contained a conforming amendment to paragraph 703.14(b) changing references to paid-in capital and membership capital to perpetual capital and nonperpetual capital accounts, respectively. The final 703.14(b) is adopted as proposed.

## **C. PART 704 CORPORATE CREDIT UNIONS**

### **§ 704.2 Definitions**

New and modified definitions in §704.2 are discussed below in the section where the defined word or phrase appears.

### **§ 704.3 Capital**

Section 704.3 establishes the capital requirements for corporates. The final 704.3 contains six paragraphs (a) through (f). Paragraph (a) covers the basic capital requirements. Paragraph (b) contains the requirements for nonperpetual capital accounts (NCAs) and paragraph (c) contains the requirements for perpetual contributed capital (PCC). Paragraph (d) contains the requirements

and procedures for establishing different minimum capital requirements for a particular corporate. Paragraph (e) contains certain other reservations of authority to the NCUA Board. Paragraph (f) explains the treatment of certain former capital accounts under the old corporate rule (i.e., membership capital accounts) that are not converted to the new forms of capital (i.e., either NCAs or PCCs).

As discussed previously, this new 704.3 capital section will not become effective until [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], and some elements of this section, and associated definitions, have effective dates that are delayed beyond [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

704.3(a) Capital requirements.

The proposed 704.3(a), along with associated definitions in 704.2, established a new leverage ratio, new Tier 1 risk based capital ratio (T1RBC ratio), and a new total risk based capital ratio (Total RBC ratio). The proposal established minimum of 4 percent for the leverage ratio, 4 percent for the T1RBC ratio, and 8 percent for the Total RBC ratio. The proposal required a corporate develop goals, objectives, and strategies to ensure adequacy of capital. The proposal required that a corporate attempt to build RE to a level of 0.45 percent of its moving daily average net assets (DANA) within 36 months of publication of the final rule, and submit a RE accumulation plan (REAP) to NCUA if it fails to do so.

The final rule generally adopts 704.3(a), and the associated definitions, as proposed. Some commenters, however, sought clarification about certain provisions, as discussed below.

704.3(a)(1)(i) and 704.2 Definitions of leverage ratio.

A few commenters expressed confusion about the effective date of the new leverage ratio, and whether that date was actually 12 months following publication of the final rule, or 36 months as stated in the preamble. In fact, the permanent leverage ratio will become effective 36 months after publication, but the rule does contain an interim leverage ratio to bridge the gap between the general effective date of the capital provision (i.e., 12 months after publication) and the permanent leverage ratio.

The proposal, between 12 months and 36 months following publication of the final rule, requires a minimum 4 percent interim leverage ratio, which was defined

as the adjusted total capital divided by moving DANA. The proposed definition of “total capital” included RE, PCC, and NCAs, while the proposed definition of “adjusted total capital” then excluded all NCAs in excess of the amount of PCCs. This result would have limited the use of NCAs to only 200 BP toward the 400 BP necessary to achieve the minimum leverage ratio.

Two corporate commenters suggested that corporates be allowed to use NCAs, without limit to satisfy their interim leverage ratio (that is, until the 36 month point). One stated that the current calculation of interim leverage ratio will result in NCAs not being an effective capital tool. This commenter believes that under the proposal as drafted corporates will immediately solicit PCC following publication of the final rule so as to be in compliance with the interim leverage ratio at the 12 month mark. This commenter suggests, instead, that NCUA redefine the numerator of leverage ratio from “adjusted total capital” to “total capital,” thus allowing for unrestricted use of NCAs in the numerator until at least the third anniversary of publication of the final rule. This commenter states this will give NPCUs additional time to decide whether they want to stay in the corporate system and invest permanently in the corporates through PCCs, and will also improve the corporate’s ability to grow RE in the first three years, as NCAs are less expensive than PCCs.

The Board agrees with these commenters. Accordingly, in the final rule the numerator of the interim leverage ratio includes all elements of capital and permits the use of any one element without limitation. Hence, a corporate could use just NCAs, if it desires, to satisfy the 4 percent interim leverage ratio requirement. Thirty six months after publication of the final rule, the proposal defined, and this final rule adopts, the permanent leverage ratio to be defined as adjusted core capital divided by moving DANA. Core capital, in turn, is limited to Tier 1 capital (i.e., RE and PCCs). Accordingly, NCAs will not count at all toward the permanent leverage ratio when it becomes effective after 36 months. The final rule also adds clarifying statements at the end of each of the two definitions, that is “[T]his is the interim leverage ratio,” and “[T]his is the permanent leverage ratio,” so that those who read the definitions will understand that these are two distinct definitions.

#### 704.2 Definition of “core capital”

The proposal defines core capital as the sum of the corporate credit union’s RE, paid-in capital, and the RE of any acquired credit union, or of an integrated set of activities and assets, calculated at the point of acquisition, if the acquisition was a

mutual combination. Upon the first anniversary of the publication of the final rule, the new Basel I capital provisions and ratios become effective. On that date, the proposal adjusts the definition of core capital to make a nomenclature change (i.e., replace PIC with PCC) and to add to capital the minority interests in the equity accounts of CUSOs that are fully consolidated with the corporate.

#### 704.2. Definition of “adjusted core capital”

The permanent leverage ratio and the Tier 1 risk based capital ratio use adjusted core capital as the numerator. The proposal defined adjusted core capital as core capital modified by six different deductions.

The proposed deductions required when adjusting core capital include the amount of the corporate’s investments in consolidated CUSOs. Some commenters objected to this deduction, arguing that such a deduction varies from the Basel I standards. The Board agrees that this proposed deduction, as worded in the proposed, did not accurately reflect the Basel I standard. The deduction should be for investments in CUSOs that are not consolidated with the corporate, as described in the Basel I Accord:

It has been concluded that the following deductions should be made from the capital base for the purpose of calculating the risk-weighted capital ratio. The deductions will consist of: . . . investments in subsidiaries engaged in banking and financial activities **which are not consolidated** in national systems. The normal practice will be to consolidate subsidiaries for the purpose of assessing the capital adequacy of banking groups. Where this is not done, deduction is essential to prevent the multiple use of the same capital resources in different parts of the group. The deduction for such investments will be made against the total capital base. The assets representing the investments in subsidiary companies whose capital had been deducted from that of the parent would not be included in total assets for the purposes of computing the ratio.<sup>9</sup>

---

<sup>9</sup> INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (July 1988, UPDATED TO April 1998), Section I(c), paragraph 24(ii)(emphasis added). See also 12 C.F.R. Part 3, Appendix A, §2(c)(7)(i)(Office of the Comptroller of the Currency deductions from capital), and 12 C.F.R. Part 208, Appendix A, §11.B.(ii)(Federal Reserve Board deductions from capital).

The Board has amended the final definition of adjusted total capital to required deduction of investments in unconsolidated CUSOs.

The proposed definition of adjusted core capital also requires that corporates should deduct from their own capital any capital they have contributed to other corporates. Specifically, the proposal stated:

If the corporate credit union, on or after (the first anniversary of the final rule), contributes new capital or renews an existing capital contribution to another corporate credit union, deduct an amount equal to the aggregate of such new or renewed capital . . .

Some NPCU commenters specifically agreed with this deduction, noting that cross-corporate capitalization can inflate capital levels and exposes NPCU members of the contributor corporate to the problems of another corporate.

One commenter asked for clarification about the meaning of “renew an existing capital contribution.” The only capital placed in another corporate that is exempt from this required deduction is existing PIC that is converted directly to PCC on the first anniversary of the publication of the final rule or unconverted MCAs that are amortizing under the provisions of paragraph 704.3(f). All other PCC, and all NCAs, must be deducted. For clarity, the Board has amended the final version of the rule text to read as follows:

If the corporate credit union, on or after (the first anniversary of the final rule), contributes any PCC, or maintains any NCAs, at another corporate credit union, deduct an amount equal to this PCC or NCA  
...

Another commenter said NCUA should consider an exception for de minimus member capital contributions between corporates. The Board considered this last comment, but does not believe a de minimus exception is necessary.

One commenter objected to this proposed deduction, stating that it seemed to indicate that NCUA would consider any capital deposits made by NPCUs into corporates to have a 100 percent risk weighting, if and when NPCUs might fall under a risk-weighted capital system, and this would further hinder corporate recapitalization. The Board does not believe that NPCU’s should equate capitalization by NPCUs of retail corporates with cross-capitalization of corporates for purposes of PCA.

One commenter stated that the definition of core capital should include NCAs. The Board disagrees. Adding NCAs to the definition of core capital would undermine the permanent nature of core capital and the associated capital protection provided by the minimum leverage ratio.

#### 704.2 Definition of “supplementary capital”

The proposed definition of supplementary capital included NCAs, a portion of the corporates allowance for loan and lease losses, and a portion of the unrealized gains on available for sale equity securities with readily determinable fair values. The term, which is synonymous with Tier 2 capital, is used in the numerator of the total risk based capital ratio. One commenter suggested that all of the unrealized gains on equity securities should count as supplementary capital. The Board disagrees, as this approach would be inconsistent with the Basel I regulations of the other banking regulators.<sup>10</sup> The Board also notes that corporates are not likely to have much in the way of equity securities, as they are generally impermissible investments for corporates.

#### 704.2 Definition of “Fair value.”

The final rule also refines the definition of fair value to read as follows, consistent with Financial Accounting Standard 157:

Fair value means the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. If there is a principal market for the asset or liability, the fair value measurement is the price in that market (whether that price is directly observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date. In the absence of a principal market, the fair value measurement occurs in the most advantageous market for the asset or liability. The fair value of the asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, the corporate need not identify specific market participants. Rather, the corporate should identify characteristics that distinguish market participants generally, considering factors

---

<sup>10</sup> See, e.g., 12 C.F.R. part 208, Appendix A, §II.A.2.(e)(Federal Reserve supplementary capital elements).

specific to all of the following: a. The asset or liability; b. The principal (or most advantageous) market for the asset or liability; and c. Market participants with whom the corporate would transact in that market. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). Examples of valuation techniques include the present value of estimated future cash flows, option-pricing models, and option-adjusted spread models.

#### 704.2 Definition and use of “moving monthly average net risk-weighted assets”

The proposal defined the denominator of both new risk based capital ratios as “Moving Daily Average Net Risk-weighted Assets” (MDANRA). Some commenters questioned the burden of daily risk weighting to produce the MDANRA figure. The Board agrees that a daily calculation is not necessary and could be quite burdensome for some corporates. Accordingly, the final rule replaces the denominator of both risk based capital ratios with a new moving monthly average net risk-weighted assets (MMANRA), defined to mean the average of the net risk-weighted assets for the month being measured and the previous eleven (11) months. The definition also requires that MMANRA measurements be taken on the last day of each month.

#### 704.2 Definition of “retained earnings.”

The final rule amends the definition of retained earnings to create a cross reference to GAAP: “Retained earnings means retained earnings as defined under Generally Accepted Accounting Principles (GAAP).”

#### 704.3(a)(3) RE accumulation target and REAP

Some commenters incorrectly characterized the proposal as establishing a “requirement” for 45 BP of RE after three years, and questioned the feasibility of reaching that target under the proposed ALM and investment restrictions (discussed elsewhere). In fact, the proposal does not require 45 BP after three years, but, rather, calls for the submission of a RE accumulation plan (REAP) if the 45 BP target is not met.

Many commenters, including both NPCUs and corporates, thought that the multi-step RE phase-in (i.e., target of 45 BP after three years, and a requirement for 100 BP after six years, and then 200 BP after ten) was too difficult for corporates to achieve. Commenters thought this was too difficult because of the current interest rate environment; the fact that most corporate income comes from investments, and not loans; and the limitations imposed by the proposed ALM and investment requirements (discussed elsewhere). One of these commenters stated this RE timetable was likely to encourage aggressive strategies to accumulate RE or cause a corporate “to solicit high cost capital,” and that corporates “must not be unnecessarily forced into a survival mode while rebuilding capital.” Many of these same commenters suggested that these milestones be changed from three, six, and ten years to four, eight, and twelve years, respectively. One of these commenters asked that these milestones be changed to five, seven, and twelve years, respectively. One corporate commenter, however, did state its belief that these RE targets and requirements were achievable.

The Board disagrees with those commenters who believe the proposed time line is not achievable. The proposed timeline, which the Board has adopted in the final, provides the necessary balance between permitting a well-run corporate time to solicit capital and grow retained earnings, while ensuring that there is pressure on the corporate to achieve adequate capital levels.

Of the commenters who specifically thought requiring 100 BP of RE by year six was too aggressive, one asked that NCUA make public its third-party review of this requirement, along with the assumptions used during the review. As discussed above, NCUA has made public the Kamakura report, and has made changes in response to portions of the report. Overall, NCUA believes these changes will make it easier for a corporate to achieve the necessary RE growth, as discussed in more detail below.

One commenter stated that the proposal should require a state chartered corporate submit any REAP to both NCUA and the relevant state regulator, and that NCUA consult with the state regulator on the evaluations of the REAP. The NCUA Board agrees that it should consult with the relevant state regulator in these circumstances, and has amended the final regulation accordingly.

Except as described above, the Board adopts the final paragraph 704.3(a), and associated capital definitions in §704.2, as proposed.

704.3(b) Requirements for nonperpetual capital accounts (NCAs).

The proposal replaced membership capital accounts (MCAs) with nonperpetual capital accounts (NCAs). NCAs must be either term or notice accounts, with a minimum maturity or notice period of five years. Under the proposal, adjustable balance NCAs were not permitted.

Two commenters stated that five-year notice is more appropriate than three-year notice, since “this three year time period is short in relation to the term of some corporate assets.” These commenters, however, believe that all contributed capital should be five-year notice and that there is no need for perpetual contributed capital. The Board believes it is important to have some element of perpetual capital in corporates. This is consistent with Basel I and with the fact that, going forward, corporates cannot expect any future extraordinary government intervention.

One NPCU stated that NCUA should continue to permit accounts that adjust with credit union balance sheets. This commenter stated that such adjustable accounts are “necessary for the system and in times of tight liquidity allows credit unions to have flexibility.” The Board disagrees. Capital must have a sense of permanence. Capital accounts that adjust based on measures that can be manipulated by the member lack this permanence.

One commenter asked that, with regard to the new NCAs, the word “original” be placed in front of the phrase “minimum term.” The Board agrees and has made this clarification.

Two commenters recommended that, for “nonmaturity” or “notice” NCAs, the withdrawal notice be changed from five years to three years if the NCAs have been in existence at the corporate for at least two years. The Board believes this change would be confusing to implement, would undermine the stability of NCAs, and would be inconsistent with the Basel standards. Accordingly, the Board is not adopting this recommendation.

A few commenters objected to the proposed change from three years to five and said MCA maturity should stay at three years; and one billion dollar NPCU stated that the proposed extension to five years could cause some credit unions to leave the corporate network. A few NPCUs stated that if NCUA wanted NPCUs to recapitalize corporates, it would shorten the term of MCAs instead of lengthening the term, and one of these NPCUs suggested a term of one to two

years. The Board believes that the importance of having solid, perpetual capital, consistent with the international Basel I standards, outweighs these concerns.

Another commenter stated that credit unions will need the flexibility to withdraw or change to another corporate credit union that meets their needs without having to wait three to five years to withdraw a capital deposit. The Board disagrees. Capital by its very nature must be stable and not subject to easy withdrawal. As discussed above, potential creditors and vendors of a corporate will not do business with the corporate absent a strong capital regime that is available to absorb losses ahead of these third parties.

704.3(b)(6), (c)(5). Permitting the transfer of contributed capital accounts (NCA and PCC) to third parties.

The proposal would permit members to freely transfer their NCAs (704.3(b)(6)) and PCCs (704.3(c)(5)) to third parties, regardless of membership status.

One NPCU commenter stated that free transferability of capital was good, as it helped enforce market discipline. A few commenters, however, stated that there should be limits on the ability of a member to unilaterally sell or transfer their contributed capital to any other member or a nonmember. These commenters believe that a corporate credit union's board must be empowered to preapprove any proposed transfer of capital funds (other than in a merger or liquidation). One of these commenters would restrict transfers to other entities in the field of membership, and another commenter stated that:

It does not appear that the corporate credit union would have any ability to control the transfer of or the ultimate ownership of its capital shares. This lack of control could lead to the required registration of capital shares as public securities. Such a registration could be required despite the wishes of the corporate and the majority of its members. Registration would dramatically increase the cost and complexity of operating a corporate. In addition, the free transfer of capital shares could allow manipulation including enabling natural person credit unions to cut their capital exposure to a corporate by selling shares rather than by putting them on notice. Alternatively, a prospective member credit union could buy shares rather than contributing capital directly to a corporate. This regulation would hamper the objective of building committed corporate capital.

The Board agrees that there should be additional limits on the transferability of NCAs and PCCs to mitigate the possibility of securities laws violations. PCC and NCAs are generally subject to the securities laws because they meet the general definition of “security.”<sup>11</sup> Securities issued by corporate credit unions are exempt from registration under the Securities Act of 1933 (SA),<sup>12</sup> and since it is unlikely that either members or corporates would engage in activities involving PCC or NCAs that would trigger the application of broker/dealer provisions of the Securities and Exchange Act of 1934 (SEA), the risk of securities law violations is minimal. Still, the anti-fraud provisions of SEA §10(b) and SEC Rule 10b-5 would apply to any transfer, so that members should not withhold, or misstate, any available financial information about the corporates when making such a transfer and should also ensure that the potential transferees have some sophistication.<sup>13</sup>

Accordingly, the final rule requires a corporate member wishing to transfer PCC or NCAs to a non-credit union third party must ensure the potential transferee obtains appropriate financial information about the corporate. To ensure the proper flow of information, the rule provides that the member must notify the corporate at least 14 days before consummating the transaction, and the corporate must then provide both the member and the potential transferee all financial information about the corporate available to the members or the public, including any call report data submitted by the corporate to NCUA but not yet posted by NCUA.

The final rule also limits such transfer to nonnatural persons. This serves a consumer protection function and is also consistent with NCUA’s rules on the sale of secondary capital at low income credit unions.

704.2 Definition of “available to cover losses that exceed retained earnings.”

NCAs must be “available to cover losses that exceed retained earnings and perpetual contributed capital.”<sup>14</sup> The quoted phrase is defined in proposed 704.2, and the definition provided that “[t]o the extent that contributed capital funds are used to cover losses, the corporate credit union must not restore or replenish the affected capital accounts under any circumstances.” Some commenters believe

---

<sup>11</sup> See, e.g., 15 U.S.C. 77b(a)(1), 15 U.S.C. 77c(a)(10).

<sup>12</sup> See 15 U.S.C. 77c(a)(5), and Securities and Exchange Commission (SEC) Release No. 33-6758, Regulation D Revisions, 53 FR 7866, note 10 (March 3, 1988).

<sup>13</sup> See 15 U.S.C. 78j(b).

<sup>14</sup> And PCCs must be “available to cover losses that exceed retained earnings.” 12 CFR 704.2.

that this is a new requirement. In fact, it is not a new requirement, but simply a clarification of an existing requirement. The proposal also provided that contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has no claim against the liquidation estate. To avoid the ambiguity associated with different possible fiscal years, the final rule replaces “fiscal year” with “calendar year.” The entire final definitions now read as follows:

*Available to cover losses that exceed retained earnings* means that the funds are available to cover operating losses realized, in accordance with generally accepted accounting principles (GAAP), by the corporate credit union that exceed retained earnings net of equity acquired in a combination. Likewise, *available to cover losses that exceed retained earnings and perpetual contributed capital (PCC)* means that the funds are available to cover operating losses realized, in accordance with GAAP, by the corporate credit union that exceed retained earnings net of equity acquired in a combination and PCC. Any such losses must be distributed *pro rata* at the time the loss is realized first among the holders of PCC, and when all PCC is exhausted, then *pro rata* among all nonperpetual capital accounts (NCAs) and unconverted membership capital accounts, all subject to the optional prioritization described in Appendix A of this Part. To the extent that any contributed capital funds are used to cover losses, the corporate credit union must not restore or replenish the affected capital accounts under any circumstances. In addition, contributed capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.<sup>15</sup>

Except as discussed above, the Board adopts the final paragraph 704.3(b), and associated definitions in §704.2, as proposed.

704.3(c) Requirements for perpetual contributed capital (PCC)

The proposal renamed paid in capital (PIC) as perpetual contributed capital (PCC). Generally, the proposed terms and conditions for PCC tracked those of the existing PIC, with the following exceptions.

---

<sup>15</sup> The final revisions to the corporate rule contain two different versions of the definitions section (§704.2): a temporary version that goes into effect with the bulk of the revisions 90 days after publication in the Federal Register, and a permanent version that goes into effect one year after publication on the effective date of the capital and PCA provisions. This quoted definition of *Available to cover losses that exceed retained earnings* is the permanent version of the definition. The temporary version refers to PIC and MCAs, not PCC and NCAs.

The existing rule permits a corporate to call PIC if the corporate would meet its minimum levels of capital and NEV ratios after redemption; the proposal requires NCUA's prior approval for any such redemption. The proposal permits the free transferability of PCC to certain nonmember third parties, under the same conditions as NCAs may be transferred (as discussed above). The proposal also eliminated the existing prohibition on conditioning membership, services, or prices for services on a member's ownership of PIC (now to be renamed PCC).

#### 704.3(c)(3) Callability of PCC

Many commenters objected to the 704.3(c)(3) proposal that NCUA must preapprove a corporate's determination to call, or redeem, PCC. Some of these commenters believe NCUA preapproval is overreaching and unnecessary in light of other provisions in the proposed regulation. Some of these commenters stated that the corporate should be free to permit redemption of PCC, without NCUA preapproval, so long as the corporate would continue to meet its minimum capital requirements. Two commenters stated that this prohibition might discourage members from contributing PCC. One stated that over time RE will replace much of the PCC, and that should reduce NCUA's concerns with PCC redemption.

PCC will fulfill a central role in corporate capital structures for many years to come. The Board wishes to ensure that, before a corporate lets any PCC go through redemption, the corporate truly does meet its minimum capital and NEV levels, and is likely to maintain those levels into the foreseeable future. Accordingly, the final rule retains the proposed requirement for NCUA preapproval of any PCC redemption.

#### 704.3(c)(6) Conditioning membership, services, and prices of services on purchase of PCC

Many commenters recommended that NCUA not eliminate the current prohibition on a corporate conditioning membership, services, or prices for service on a credit union's ownership of PIC (PCC going forward). One of these commenters stated that granting the corporates the ability to condition payment services or other services on "membership" could force only those NPCUs who have no other alternative to place more capital at risk and out of their control. Another NPCU commenter stated that it learned from the Capital Corporate collapse in the 1990's and has avoided buying capital shares, and does not want to be forced to contribute capital going forward.

Many other commenters, however, including many NPCU commenters, supported the full elimination of this prohibition. Most of these commenters believe this sort of decision on requiring capital contributions is appropriately left to the board and management of the corporate credit union. One commenter stated that lifting this prohibition was necessary to protect against free riders, noting that because of this prohibition the current distribution of losses among members of corporate was unfair.

A few NPCU commenters even thought a corporate should require member capital to receive services. Some of these commenters thought that the requirement should be linked to the amount of the NPCU's deposits at the corporate, and others to an NPCU's asset size, and some stated that larger NPCUs should not be permitted to subscribe to lesser amounts of capital as a percentage of asset size.

In the Board's view, corporates are designed to service NPCUs, and NPCUs own the corporates and the associated risks and rewards of such ownership. If NPCUs believe that corporates provide some valuable or essential service, then NPCUs will need to capitalize the corporates. Accordingly, the Board believes it is appropriate that a corporate be given the option of conditioning its membership, services, or the prices for services, on the purchase of PCC. This authority helps the corporate protect itself from free riders, that is, those NPCUs and other entities that want the benefits of the corporate without taking on any risks. The Board does not believe that NCUA should, by rule, require some minimum amount of capital contribution, but does believe that the corporate's board should have the authority to do so.

Several commenters stated, however, that if this prohibition is eliminated, the regulation should make clear that corporates cannot change their policies so as to threaten *immediate* termination of essential services absent immediate PCC contributions. Many of these commenters suggested that an NPCU that refuses to meet a new demand for contributed capital be given at least 12 months to find another service provider.

The Board appreciates the concern of these commenters. Corporate members should be given adequate time to look for alternatives should they find any particular, proposed conditions on membership, services, or the prices for services too onerous. The Board believes, however, that six months to find an alternative service provider should be appropriate. Accordingly, the final paragraph 704.3(c)(6) provides that a corporate must give a member at least six

months written notice of (i) the requirement to purchase PCC, including specific amounts; and (ii) the effects of a failure to purchase the requisite PCC on the pricing of services or on the member's access to membership or services.

One NPCU commenter stated that if corporates are permitted to require capital contributions as a condition of membership or services, the NCUSIF should insure the capital contribution. Another NPCU commenter stated that capital should be "portable," meaning that if an NPCU wishes to move to another corporate because they may not be satisfied with the services being offered, then the NPCU should be free to shift its existing capital to the new corporate without any conditions or time constraints. Again, these commenters misunderstand the fundamental nature of capital. Capital is a buffer to ensure that creditors and vendors of a corporate will not be first in line to absorb operating losses. If NCUA insured the capital, that would be transferring the risk from the member-owner to the entire universe of insured credit unions, and that is not appropriate. Further, if NCUA permitted capital to be "portable," it would undermine this primary role of capital as assuring potential creditors and vendors of the corporate of the continued availability of that capital to absorb operating losses.

#### 704.2 Definition of Tier 2 Capital includes certain PCC

Paragraphs (5) and (6) of the proposed definition of adjusted core capital excludes certain PCC that exceeds certain levels of RE. The purposes of these exclusions is to force corporates to build up their RE for inclusion in adjusted core capital and inclusion in the corresponding leverage ratio and Tier 1 risk based capital ratios. The effect of these provisions, however, was to also exclude the excess PCC from all capital calculations, including Tier 2 capital ratios.

Some commenters stated that all PCC should continue to count as capital. They ask that some other method be used to encourage RE growth but, if not, then in the alternative that excess PCC should continue to count as at least Tier 2 capital (i.e., and count toward the total RBC ratio). These commenters understood that the proposal intends to push corporates toward building RE growth, but they argue that any existing excess PCC still protects the corporate from losses. Two commenters stated that to the extent PCC does not count as capital it should be returned to the members.

The Board agrees that excess PCC should continue to count as Tier 2 capital. Accordingly, in the final rule the Board amends the definition of Tier 2 capital to include “any perpetual capital deducted from adjusted core capital.”

#### 704.2 Definition of equity investments

The proposal uses the term equity investments as a deduction for purposes of calculating adjusted core capital, and defines the term in 704.2 to include only investments in real property and equity securities. One commenter pointed out that equity investments can also take the form of investments in partnerships or limited liability companies. Accordingly, the final rule amends the definition to read as follows:

Equity investments means investments in real property, equity securities, and any other ownership interests, including, for example, investments in partnerships and limited liability companies.

Accordingly, and except as described above, the Board adopts the final paragraph 704.3(c), and associated definitions in §704.2, as proposed.

#### 704.3(d) Individual minimum capital requirements

Proposed paragraph 704.3(d) gave NCUA the authority to require higher minimum capital requirements of individual corporate credit unions. The proposal provided the corporate with notice and an opportunity to respond in writing before imposition of the new capital requirements.

Many commenters opposed this paragraph as giving too much discretionary power to NCUA and NCUA examiners. Some of these commenters mistakenly believe that the proposal delegates this authority to the OCCU Director or some other “individual.” In fact, the proposal provides this authority to the “NCUA,” meaning the “NCUA Board” (unless further delegated by the Board). The Board believes that this provision gives the Board powers it needs to ensure the health of the corporate system and the credit union system as a whole. The Board does agree that some additional due process may be appropriate, as discussed below.

704.3(d)(4) Standards for determination of new minimum capital requirement

Some commenters objected to the language in proposed 704.3(d)(3) stating that “levels for an individual corporate cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria. The decision is necessarily based in part on subjective judgment grounded in agency experience.” These commenters thought this language was too subjective, and that it departed from the models of the other banking regulators that NCUA was purporting to follow. In fact, this statement is true. Further, the same language does appear in the regulations of the other banking regulators. See, e.g., 12 CFR 3.11 (OCC Regulation). Accordingly, the final rule retains this language.

#### 704.3(d)(4) Procedures for imposing new minimum capital requirement

The proposal does provide the corporate due process, that is, notice and an opportunity to respond in writing. The proposal generally provides that a corporate will have 30 days to respond to the notice, but that NCUA may shorten this period for good cause, and two commenters stated that the corporate should have at least a minimum time of 15 days to respond. One of these commenters stated that such powers should be exercised only by the NCUA Board, and not be delegable. Another commenter stated that, for state chartered corporates, the regulation should require the NCUA Board obtain the concurrence of the state regulator before exercising this authority.

The Board agrees that additional due process may be warranted in some cases. Accordingly, the final rule includes a new paragraph 704.3(d)(4)(vi) that permits a corporate to request an informal hearing. The corporate must make the request in writing, and NCUA must receive the request no later than 10 days following the initial notice of NCUA’s intent to establish a different minimum capital requirement. Upon receipt of the request for hearing, NCUA will conduct an informal hearing and render a decision using the procedures described in paragraphs (d), (e), and (f) of Section 747.3003.

Some of these commenters also objected to the statement that the NCUA decision on this matter represents “final agency action.” However, this statement is true as there is no administrative appeal from NCUA’s decision in this matter. Accordingly, the final rule retains this language.

Except as described above, the Board adopts the final 704.3(d) as proposed.

#### 704.3(e) Reservation of authority.

The proposed paragraph 704.3(e) provided for various reservations of authority to NCUA.

Proposed paragraph 704.3(e)(2) gave NCUA the authority to require a corporate to use period end assets, instead of moving DANA, for purposes of calculating capital ratios. One corporate commenter objected to this proposed authority, stating that month-end assets can be more than 10 percent higher than DANA for the month. This commenter suggested NCUA adopt an objective standard for the use of this authority, such as where month-end assets are at least 125 percent of DANA for three consecutive months. Another commenter stated that corporates should be given the option of using average or period end assets, as NPCUs are permitted to do under the PCA regime. The Board disagrees, and refuses to put such limits on its authority to require the use of period-end assets in appropriate cases.

Proposed paragraph 704.3(e)(3) gave NCUA authority to discount a particular asset or capital component of a particular corporate from the computation of capital. Some commenters opposed this as giving too much power to NCUA, the OCCU Director, and NCUA examiners. One commenter stated that no corporate should be treated differently from others just because of the examiner. The provision, however, only empowers the NCUA Board, not the OCCU Director or NCUA examiners (unless the Board delegates its authority).

A few commenters correctly noted that the proposal does not provide for any particular due process before NCUA acts. Another commenter believes that there should be some stated time for the corporate to correct the deficiency that gave rise to the unsatisfactory rating.

The Board agrees that there should be some due process associated with its reservations of authority under paragraph 704.3(e), and the final rule adds a new paragraph 704.3(e)(5) setting forth such due process. Before taking any action under paragraph (e), NCUA will provide the corporate with written notice of the intended action and the reasons for such action. The corporate will have seven days to provide NCUA with a written response, and NCUA will consider the response before taking the action. Upon the timely request of the corporate credit union, and for good cause, NCUA may extend the seven day response period.

704.3(f) Former capital accounts.

Many commenters suggested that three-year MCAs that are not converted to five year NCAs be permitted to count as capital, and some stated that they should count on a two year declining basis. These commenters argued that MCAs were available for some loss protection until such time as they were converted or returned and so should count in some way toward the corporate's capital requirements. One commenter asked whether NCUA would permit the corporate to return to its members three-year MCAs that were not converted to five-year NCAs.

The Board agrees that some corporate members may refuse to convert their existing three-year MCAs to the new five-year NCA or to perpetual PCC prior to the effective date of the new capital rules (i.e., the first anniversary of the publication of the final rule in the Federal Register). The Board also agrees that the entire balance of these accounts is available to absorb losses until the account is closed, and that these unconverted MCAs should count, at least partially, as Tier 2 capital. Accordingly, the final rule adds a new paragraph 704.3(f) that provides, effective on the first anniversary of publication of the final rule, unconverted MCAs will be treated as follows:

- *For “adjustable balance” MCAs*, the corporate will immediately put those accounts on notice of withdrawal (if they are not already on notice). The corporate will continue to adjust the balances of the MCA account in accordance with the original terms of the account until the entire notice period has run and then return the remaining balance, less any losses, to the member. Until the expiration of the notice period, the entire adjusted balance will be available to cover losses that exceed RE and certain contributed capital. The corporate may count the unconverted MCAs as Tier 2 capital on an amortizing basis, using the amortization method described in proposed 704.3(b)(3).<sup>16</sup> Corporates will also be required, on the first anniversary of the publication of the final rule, to provide members who hold unconverted MCAs a one-time disclosure about the status of their MCA accounts.
- *For three-year term MCAs*, the corporate will return the MCAs at the expiration of the three-year term. Again, until the expiration of three year term, the entire account balance will be available to

---

<sup>16</sup> This amortization method reduces the amount that counts towards capital to zero when one year is remaining on the notice period or term. This amortization method also assumes that the adjustment is determined based on a relatively permanent measure, such as the member's assets, and not on some impermanent measure, such as the member shares at the corporate.

cover losses that exceed RE and certain other contributed capital. The corporate may count the unconverted MCAs as Tier 2 capital on an amortizing basis, using the amortization method described in proposed 704.3(b)(3). Corporates will also be required, on the first anniversary of the publication of the final rule, to provide members who hold unconverted MCAs a one-time disclosure about the status of their MCA accounts.

### **Part 704, Appendix A – Capital Prioritization and Model Forms**

The current Appendix A to part 704, entitled Model Forms, contains forms that members provide the corporate on an annual basis acknowledging the terms and conditions of the members' PIC and MCA accounts. The proposal renamed Appendix A as Capital Prioritization and Model Forms.

The proposed Appendix A had two parts. Part I, which is new, provided the corporate's board of directors an option to give entities that contribute new capital to the corporate priority – in terms of availability to absorb losses and payout in liquidation -- over existing capital contributions. New capital in this context was defined as any capital contributed more than 60 days following the publication of the final rule. The purpose of this provision is to provide a tool to the corporate for facilitating capital growth. Part II contained amended model disclosure forms that cover MCAs, PIC, NCAs, and PCCs. The forms included variable disclosures depending on whether the corporate exercises the option described in Part I.

NCUA received very few comments on Appendix A, but the final rule does include two minor changes from the proposed.

Consistent with the proposed clarifying amendments to §709.5, Model Form A in Appendix A of the proposal included disclosure language that depleted capital has no claim against the liquidation estate for claims filed beyond the fiscal year of depletion. For clarity and to reduce the potential ambiguity associated with "fiscal year," the final rule substitutes "calendar year" for "fiscal year." The final rule also contains a similar revision to the payout priority paragraphs 709.5(b)(7)(for NCAs) and (b)(9)(for PCC holders):

in a case involving liquidation of a corporate credit union, holders of then-outstanding nonperpetual capital accounts or instruments to the extent not depleted in a calendar year prior to the date of

liquidation and also subject to the capital priority option described in Appendix A of Part 704 of this chapter . . . .

12 CFR 709.5(b)(7).

Also, since the effective date of the final rule will generally be ninety days following the date of publication, the final rule modifies the definition of new contributed capital for purposes of Part I, changing it from capital contributed more than 60 days following publication to capital contributed more than 90 days following publication.

Accordingly, and other than as described above, the final rule adopts Appendix A as proposed.

Part 704, Appendix B relates closely to the investment (§704.5), credit risk (§704.6) and asset-liability (§704.8) provisions of the corporate rule, and is discussed below in connection with those provisions.

### **Part 704, Appendix C – Risk weighting of assets for risk based capital calculations**

The current corporate rule has no risk weighted capital ratios or provisions. The proposal included two new minimum capital ratios defined in terms of risk-weighted assets and activities. Proposed Appendix C contained the detailed instructions for assigning risk weights, including:

- Assets that appear on the corporate's balance sheet will, generally, be risk-weighted at zero percent, 20 percent, 50 percent, or 100 percent, with less risky assets (e.g., treasury bills) given lower percentages, and more risky assets (e.g., loans) given higher percentages.
- Activities that involve risk but that may not appear on a corporate's balance sheet (e.g., an interest rate swap, or a guaranteed line of credit not yet drawn upon) are assigned a conversion factor and then risk weighted as if the underlying assets were, in fact, on the corporate's balance sheet. Recourse obligations (e.g., a recourse obligation on a transferred loan) and direct credit substitutes (e.g., a mortgage backed security that is subordinated to other securities in the same issuance) are generally treated as if the entire amount of the supported asset is on the credit union's balance sheet. Residual interests (e.g., retained,

subordinated interests in a loan or loan participation transfer, or a retained credit enhancing interest-only strip) have different, more severe risk weighting calculations.

- A corporate may employ a ratings-based risk weighting option for certain investments, (i.e., a recourse obligation, a direct credit substitute, a residual interest, or an asset- or mortgage-backed security extended in connection with a securitization) that have NRSRO ratings. When there is more than one available NRSRO rating, the corporate must use the lowest rating.

Appendix C, Paragraph I(a) Scope.

The final rule amends paragraph I(a)(4) to emphasize that this Appendix does not provide authority for corporates to invest in or purchase any particular type of asset or to engage in any particular type of activity. In other words, a corporate credit must have other identifiable authority for any investment it makes or activity it engages in. So, for example, this Appendix describes risk weightings for subordinated securities, even though the final §704.5 prohibits corporates from investing in subordinated securities and so a corporate credit union cannot invest in subordinated securities. This risk-weighting provision is retained because it is possible that a corporate could come into possession of a security that is impermissible for direct investment (e.g., through enforcement of a lien on a defaulted loan), or that such securities that are impermissible now might become permissible in the future, and Appendix C will not have to be amended to deal with those situations.

Appendix C, Paragraph II(a) Risk weighting of on-balance sheet assets.

A few commenters sought clarity on the risk weighting for ABS and MBS. Asset backed securities are risk weighted in the “all others” risk weighting category (i.e., 100 percent risk weighting) unless rated using the ratings based approach. For private label MBS that are backed by non-qualifying mortgage loans, or a combination of non-qualifying and qualifying mortgage loans, these MBS are also risk-weighted at 100 percent, again unless rated using the ratings based approach. Only MBS backed entirely by qualifying mortgages may use the 50 percent risk weighting permitted by paragraph II(a)(3)(iii).

Appendix C, Paragraph II(b) Risk-weighting of off-balance sheet items.

Paragraph II(b)(6) Off-balance sheet derivative contracts; interest rate

and foreign exchange rate contracts (Group F). –

One commenter stated that NCUA should consider excluding off-balance sheet items from the risk-based assets calculation. This commenter stated that an alternative may be to allow a corporate to establish a distinct capital pool for off-balance sheet items to prevent any confusion about the items having the same risk as on-balance sheet assets of the corporate. The Board believes the rule as proposed is clear enough on the treatment of on-balance sheet and off-balance sheet items.

One commenter noted that the proposal assigns derivative risk weights for interest rate swaps and foreign currency swaps, but not for other types of derivatives, and corporates may, if authorized by NCUA under the Expanded Authorities, engage in other forms of derivative transactions. The commenter sought clarification of this issue. The Board agrees that clarification is necessary, and so the final rule includes an “all others” catch-all category of derivative risk weighting. As with interest rate swaps and foreign currency swaps, the credit equivalent amount for these other derivatives is generally determined by summing the current credit exposure and the potential future credit exposure. Appendix C, Paragraph II(b)(6)(ii). The current credit exposure is calculated the same way for all derivatives, including other derivatives. Appendix C, Paragraph II(b)(6)(ii)(A). The potential future credit exposure is determined by multiplying the notional principal times a credit conversion factor. Appendix C, Paragraph II(b)(6)(ii)(B). The size of this credit conversion factor depends on the remaining maturity of the derivative. For the catch-all derivatives category, the conversion factors in the final rule are ten percent (remaining maturity of one year or less), 12 percent (remaining maturity of over one year but less than five years), and 15 percent (remaining maturity over five years). This treatment of these other derivatives is similar to that used by the Federal Reserve and the other banking regulators. See 12 CFR 208, Appendix A, Paragraph III.E.2.e. (Capital Regulation of the Board of Governors of the Federal Reserve).

After the credit equivalent amount is determined for any derivative, including the catch-all category, a risk weighting is applied to the credit equivalent amount depending on the nature of the counterparty. Appendix C, Paragraph II(b)(6)(iv)(A). The maximum risk weight, however, for the credit equivalent amount of any derivative contract is 50 percent.

One commenter sought clarification on the effects of collateral posted by derivative counterparties on the risk weighting of those derivatives. Appendix C only recognizes certain forms of collateral for the purposes of risk-weighting: cash, treasuries, U.S. Government agency securities, securities issued by the central governments of OECD countries, and securities issued by multilateral lending institutions or regional development banks in which the United States is a member.<sup>17</sup> The portion of the derivative's credit equivalent amount equal to the fair market value of this collateral is generally risk-weighted at 20 percent. See Appendix C, Paragraphs II(a)(2)(ii), (vii), (xiii), and (xv).

Another commenter asked whether derivatives used for hedging the credit risk of other assets in the corporate's portfolio would have a reduced, or zero, risk weighting. The answer is no. Whether or not a derivative is used for hedging is not relevant to its risk weighting for purposes of these Basel I capital ratio calculations.

*Appendix C, Paragraph II(c) Risk weighting of recourse obligations, direct credit substitutes, and certain other positions.*

Paragraph II(c)(3) Ratings based approach (RBA).

One commenter asked for clarification on the discretion of corporates to choose between a ratings-based, and non-ratings based, approach to risk weighting for those investments that carry an NRSRO rating and could be risk-weighted using the RBA. The proposed rule language could be interpreted as permitting corporates the freedom to choose their ratings approach if both the general risk weighting and RBA risk weighting might apply, and, perhaps, to apply differing approaches to differing securities on the same call report. To ensure consistency, the Board has added a new paragraph II(c)(3)(iii) to the final rule to require a corporate that uses RBA risk weighting for one or more securities on a particular call report use the RBA approach for *all* eligible securities on that call report. This requirement is consistent with how the other banking regulators have addressed this issue, at least informally. See, e.g., 73 FR 43993 (July 29, 2008) ("Regardless of the method a banking organization chooses [on a call report], it would have to use that approach consistently for all corporate

---

<sup>17</sup> Other forms of collateral, or risk-weighting percentages, may be used for risk-weighting if the derivatives counterparty is a qualified securities firm. See Appendix C, Sections II(a)(1)(viii) and II(a)(2)(viii).

exposures.”). The Board also notes that, currently, RBA is not permissible under Basel I for corporate debt obligations, even short-term debt obligations.<sup>18</sup> Without the RBA option, corporate debt will generally be risk weighted at 100 percent. The Board has determined a lower risk weight may be appropriate for highly-rated, short term corporate debt (i.e., an original or remaining final maturity of 120 days or less), as proposed by the other banking agencies in their Basel II regulations.<sup>19</sup> Accordingly, paragraph II(c)(3)(ii)(A)(1) is amended in the final rule to permit corporates the optional use of the RBA for short term corporate debt.

**§ 704.4 Prompt Corrective Action (PCA)**

The proposed PCA provisions are similar to those currently applicable to banks. Under the proposal, each corporate would be assigned to one of five capital categories: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. The potential consequences of failing to meet capital standards include restrictions on activities, restrictions on investments and asset growth, restrictions on the payment of dividends, restrictions on executive compensation, requirements to elect new directors or dismiss management, and possible conservatorship. The proposed due process for credit unions and their employees associated with the new PCA provisions was set out in a new subpart to part 747 of NCUA’s rules.

<sup>18</sup> In the proposal, the RBA is only permitted for a position that is a “recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security . . . .”  
<sup>19</sup>

Short term rating category:	Risk-weight percentage:
Highest Investment Grade	20
Second-Highest Investment Grade	50
Third-Highest Investment Grade	100
Below investment grade	150
No applicable external ratings	100

Many commenters thought generally that the imposition of PCA standards for corporates was a good idea and long overdue. A few commenters stated that the PCA powers given to NCUA under the proposal were appropriate, because as long as the possibility exists for reckless behavior at corporate credit unions, the agency needs the power to intervene. One NPCU commenter said that it at first thought the proposal gave NCUA too much power and was overreaching, but then upon further reflection changed its mind given what has happened and NCUA's central role to oversee the corporate system. One corporate commenter specifically stated that the minimum four percent (leverage and Tier 1 risk based capital ratios) and eight percent (total risk based capital ratio) were appropriate for adequate PCA capitalization.

Many commenters, however, thought that the proposed PCA provisions gave NCUA too much discretionary power and room for arbitrary decisions. Some commenters saw a general need for more clarity and certainty in the due process and appellate rights associated with PCA actions. The Board has addressed these concerns with some changes to the final rule as discussed below.

#### 704.4(a) Purpose

This proposed paragraph set forth the purpose of prompt corrective action. One sentence, related to the coordination with the state authorities for state-chartered corporates on discretionary supervisory activities, was amended and moved in the final rule to paragraph 704.4(f). The amendment is discussed below.

#### 704.4(b) Scope.

This proposed paragraph sets forth the scope of the PCA section.

704.4(b)(2). Prohibition on advertising of PCA category without prior NCUA approval.

The proposal required that no corporate may state in any advertisement or promotional material its PCA category unless NCUA specifically permits such statement or the law requires it. Many NPCU commenters stated that corporates should be required to disclose their capital category as the proposed prohibition denies transparency to the corporate's member/owners and makes it difficult for them to do their due diligence.

The Board is sympathetic to the concerns of the commenters. The members of a corporate need some transparency on the corporate's activities. The members are ultimately responsible for what the corporate does or does not do, and the members usually have both capital and uninsured shares at risk in the corporate. NCUA understands this, and will be taking additional actions in the future, such as improved call reporting requirements, to increase such transparency, at least with regard to the balance sheet. In fact, likely 99 percent of the time, a member will be able to determine a corporate's PCA status from the call report since NCUA will be requiring that a corporate report its capital levels, including its Leverage, T1RBC, and Total RBC ratios, on the call report. If members need additional financial information beyond the call report, they can request the corporate provide them the information voluntarily, or even involuntarily in response to a member petition filed under the member inspection process. 12 CFR 701.3. And, of course, the members have the ultimate power over their corporate board, since the members elect – and can refuse to reelect – board directors who are not responsive to the members.

NCUA wants to clarify one aspect of the members' rights to financial information from their corporates. Exam reports, and other documents prepared by NCUA, or prepared specifically by the corporate at NCUA's request or in response to an NCUA request, belong to NCUA and not to the corporate.<sup>20</sup> The corporate will not be able to release this information to anyone, including the corporate's members, without obtaining NCUA's prior approval.

One commenter agreed with the proposed prohibition on publicizing PCA category, but thought it needed to be clarified since certain PCA terms, such as "adequately capitalized" and "well capitalized," are common expressions and could be used unintentionally. The Board understands that such phrases might be used unintentionally, but believes it important that corporates strive as much as possible not to discuss their capital adequacy in the public media.

704.4(c) Notice of capital category.

The proposal set forth the effective date of a PCA capital category, and when the corporate must give notice to NCUA of a change in capital category, and vice versa.

704.4(c)(2)(ii). Notice of capital category.

---

<sup>20</sup> State regulators will likely have similar controls over their interactions with their state chartered corporates.

This paragraph provides for NCUA notice to the corporate of a change in capital category. One NPCU commenter complained that this provision appears to give NCUA the authority to subjectively reclassify a corporate capital classification based on administrative review, and the commenter objected to this. The Board notes that this provision does not give NCUA substantive authority to change a PCA category. Such authority arises from other provisions, such as 704.3(d)(2) and 704.4(d)(3). These provisions each have their own associated due process.

704.4(d) Capital measures and capital category definitions

The proposal set forth the various PCA capital categories and the minimum capital ratios for each category.

704.4(d)(3). Authority of NCUA, after due process, to downgrade a corporate one PCA capital category for an unsafe or unsound condition or practice.

Some commenters opposed the proposed downgrade authority in 704.4(d)(3) as giving too much power to NCUA examiners and the OCCU Director. In fact, under the proposal this authority would reside in the NCUA Board (subject to delegation), not the OCCU Director or examiners.

One commenter who opposed this provision stated that probably within the past five years every corporate would have been downgraded because it had at least one Corporate Risk Information System (CRIS) rating of three or lower.<sup>21</sup> Another NPCU commenter expressed concern that NCUA might use this power to downgrade a corporate to force an involuntary merger, resulting in a transfer of the NPCU member, and his capital accounts, to another corporate which the NPCU may not want to support. Two commenters stated that the rule needed to provide a corporate with the opportunity, and time, to correct the deficiencies leading to the adverse CRIS rating before a PCA downgrade. Two of these commenters noted that during the exam process corporates are given a time frame to correct deficiencies.

The Board believes the discretionary authority vested in it by proposed 704.4(d)(3) to downgrade a corporate is appropriate. The Board notes that it would not normally authorize a downgrade of a corporate based solely on a

---

<sup>21</sup> The proposal, however, does not require NCUA enforce a PCA downgrade because of a low CRIS rating – it only empowers the NCUA Board to take such action.

negative CRIS rating until the corporate had had a reasonable opportunity to correct the deficiencies underlying the CRIS rating.

The Board also notes that it is highly likely that there will be some corporate combinations in the coming years. While most of these mergers would be voluntary, some might be involuntary. NPCUs should take this fact into account when deciding which corporate they will use for services and how much capital they are willing to contribute to that corporate.

#### 704.4(d)(4) Modification of minimum PCA percentages.

Proposed 704.4(d)(4) permits the NCUA, for good cause, to modify any of the minimum PCA percentages for a particular corporate as provided for in 704.3(d). A few commenters objected to this provision because they thought this proposal transfers power from the NCUA Board to the OCCU Director. Again, this authority is simply a cross reference to the authority in 704.3(d). There is no delegation to the OCCU Director, and 704.3(d) provides the affected corporate with due process.

#### 704.4(e) Capital restoration plans.

The proposal described when a corporate must file a plan with the NCUA, the contents of the plan, the consequences for failure to file a plan, and NCUA's processing and approval of the plan.

#### 704.4(e)(5) Disapproval of capital plan.

Proposed 704.4(e)(5) provides that if an undercapitalized corporate does not submit a capital restoration plan acceptable to NCUA the corporate will be downgraded to significantly undercapitalized.

Two commenters protested that this allows the Director of the OCCU to treat a corporate that is undercapitalized the same as if it was significantly undercapitalized, and allows the Director to do so for an undue length of time. The Board disagrees. The PCA provisions encourage a corporate to file a timely and realistic capital restoration plan. If a corporate fails to do that, the Board must have the authority to take appropriate action to protect the corporate, its members, and the NCUSIF. In addition, the proposal makes no delegation to the OCCU Director.

#### 704.4(f) Mandatory and discretionary supervisory actions.

This proposed paragraph sets forth various mandatory and discretionary PCA actions depending on a corporate's PCA category. One commenter thought that the PCA supervisory actions that come into play depending on the corporate's PCA capital categories, and which are variously labeled within the proposal as *mandatory* or *discretionary* at the given capital category, should never be *mandatory*. Instead, they should all be *discretionary* with NCUA. The Board disagrees. The Board wants corporates to know, with certainty, that certain PCA effects will happen if a corporate falls into a particular PCA category.

A few commenters asked that, for discretionary PCA actions against state chartered corporates, if NCUA determines such an action is appropriate, NCUA give the appropriate state supervisory authority (SSA) an opportunity to take the action separately from, or jointly with, the state regulator. As pointed out by the commenters, this approach is consistent with NCUA's PCA rules for NPCUs located in paragraph 702.205(c) of part 702. Accordingly, the final rule amends paragraph 704.4(f)(2) to add the following sentence:

In addition, the NCUA will consult and seek to work cooperatively with the appropriate state supervisory authority (SSA) before taking any discretionary supervisory action with respect to a state-chartered corporate credit union; will provide notice of its decision to the SSA; and will allow the appropriate SSA to take the proposed action independently or jointly with NCUA.

704.4(g) Directives to take prompt corrective action.

The proposed paragraph requires advance notice of pending directives to significantly and critically undercapitalized corporates. There were no significant comments on this paragraph.

704.4(h) Procedures for reclassifying a corporate credit union based on criteria other than capital

The proposed paragraph requires advance notice of intent to reclassify and makes reference to the associated due process provision. There were no significant comments on this paragraph.

704.4(i) Order to dismiss a Director or senior executive officer.

The proposed paragraph provides that affected individuals are entitled to a copy of the order or directive provided to the corporate, along with notice of the right to seek reinstatement. The paragraph also makes reference to the associated due process. There were no significant comments on this paragraph.

704.4(j) Enforcement of directives.

The proposal cross references §747.3005 as the source of the process for enforcing PCA directives. There were no comments on this paragraph.

704.4(k) Remedial actions towards undercapitalized, significantly undercapitalized, and critically undercapitalized corporate credit unions.

The proposal prescribes certain remedial actions for corporates in these PCA categories.

704.4(k)(1) Prohibition on undercapitalized credit union paying dividends on capital accounts.

Proposed 704.4(k)(1) prohibited a corporate credit union from making any capital distribution, including payment of dividends on perpetual and nonperpetual capital accounts, if, after making the distribution, the credit union would be undercapitalized.

A few commenters supported this prohibition. Many commenters, however, were opposed to this prohibition, generally saying that this undermined the attractiveness of capital accounts and would discourage recapitalization of the corporate credit union system, and that the decision on payment of dividends should be left to the corporate's board of directors. One commenter stated that this prohibition could perpetuate the undercapitalized condition. Several of these commenters stated that this prohibition should be limited to significantly or critically undercapitalized corporates. Several others said that this prohibition should be tied to some sort of minimum RE ratio, not the fact that the corporate may be undercapitalized.

The Board disagrees with the commenters that oppose the prohibition. When a corporate is undercapitalized, the payment of dividends on existing capital depletes the corporate's RE and worsens the corporate's capital position, increasing the odds of the corporate's failure. The Board disagrees with those commenters that believe that a corporate must be significantly undercapitalized

before it is in true capital trouble. The undercapitalized PCA category indicates serious capital problems that the corporate must address, and anything that undermines capital retention and growth in the undercapitalized PCA category must be controlled. The Board notes that this prohibition on the payment of dividends at undercapitalized corporates is also consistent with the Basel capital regulations of the other banking regulators.

The Board does believe that the NCUA's authority to waive the prohibition as stated in the proposal is unnecessary (due to 704.1(b)), and perhaps even harmful, as this internal waiver language suggests that the NCUA might grant such dividend waivers as a matter of routine. Accordingly, the final rule eliminates the NCUA waiver authority from the text of 704.4(k)(1).

704.4(k)(2)(v). Discretionary safeguards.

This proposed paragraph stated that NCUA may, with respect to any undercapitalized corporate credit union, take one or more of the actions described in paragraph (k)(3)(ii)(e.g., for significantly undercapitalized corporates) if the NCUA determined those actions are necessary to carry out the purpose of the PCA section.

Many commenters thought this proposed paragraph went too far. Several of these commenters mischaracterized this authority as residing with the OCCU Director when, in fact, under the proposal this authority would reside in the NCUA Board (subject to delegation). Some commenters stated that under this provision, the NCUA could fire any employee and or remove any board at any existing corporate today, and will be able to do so for years to come as long as the corporates remain undercapitalized. One commenter called this provision outrageous, and two others questioned its constitutionality. Another commenter said these powers should be reserved only for corporates categorized as either significantly or critically undercapitalized.

The Board agrees with this last commenter, and has eliminated this proposed paragraph from the final rule.

704.4(k)(6)(ii)(C). Restricting the activities of critically undercapitalized corporates.

Proposed paragraph 704.4(k)(6)(ii)(C) prohibits a critically undercapitalized corporate from amending its charter or bylaws without the prior approval of

NCUA, except as necessary to carry out any other requirement of law, regulation, or order.

A few commenters stated that this usurped the authority of state regulators over state charters. The Board disagrees. A corporate that is critically undercapitalized represents a significant risk to the NCUSIF. Accordingly, the NCUA must have control over any significant activities that corporate might undertake, including, but not limited to, charter changes that affect the control or governance of the corporate.

Proposed paragraph 704.4(k)(6)(ii)(F) prohibited a corporate from paying interest on new or renewed liabilities at a rate that would increase the corporate credit union's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest on insured deposits in the corporate credit union's normal market areas. One commenter stated that corporates under PCA should not be restricted to dividend rates in the region the institution is located since some corporates have national fields of membership.

The Board notes that most corporates, even with national FOMs, have a concentration of members within a particular area of the country. In the case of a corporate which has no such identifiable concentration, the market area of the corporate would be the entire nation. Accordingly, the Board sees no need to amend the paragraph as proposed.

704.8(j)(2)(ii) Proposed PCA downgrade for failure to correct NEV test failures.

The proposed paragraph 704.8(j)(2) in the asset liability section, would require PCA category downgrades for failure to correct NEV test failures. One commenter recommended that PCA compliance and regulatory remedies be eliminated for the NEV type testing, stating that there was no precedent for the application of PCA beyond the three "routine capital measures." The Board strongly disagrees. Corporates must comply with the corporate rule's NEV requirements. And, if a corporate fails to comply, NCUA must have the supervisory tools to deal with such noncompliance. The PCA downgrade provisions in 704.8(j)(2)(ii) provide the NCUA with the necessary tools.

One commenter suggested that there should be a phase-in period for the new PCA requirements, but this commenter did not indicate whether the desired phase-in was over and above the 12 months currently envisioned under the

proposal. The final rule retains the one year phase-in of the PCA provisions as proposed.

Except as discussed above, the Board adopts the final §704.4 as proposed.

The proposal also included a new subpart M to Part 747, setting forth the procedures and due process available in connection with the PCA provisions of §704.4. The proposal adopts subpart M as proposed.

### **704.5 Investments.**

#### 704.5(a) through 704.5(g)

The proposal did not contain any amendments to these seven paragraphs, and they remain as in the current rule.

#### 704.5(h) Prohibitions.

The proposed paragraph 704.5(h) added prohibitions on corporate credit unions investing in collateralized debt obligations (CDOs) and net interest margin securities (NIMs).

Many commenters supported the prohibition on CDOs and NIMs, and the final rule retains these prohibitions. Many commenters also stated a desire for additional restrictions on corporate investments. These additional restrictions ranged from limiting corporate credit unions to investing only in government securities to additional prohibitions on securities, including residential mortgage-backed securities (RMBS) and subordinated securities that caused the credit union industry so much of a loss. NCUA hired Kamakura Corporation (Kamakura) to assist in analyzing the proposed rule, and Kamakura also recommended prohibiting investments in subordinated securities and placing further limits on private label RMBS.<sup>22</sup>

The Board agrees with these commenters and, accordingly, has added a new paragraph (h)(7) to the final rule to prohibit corporates from investing in private label RMBS. Private label RMBS are not guaranteed by the United States Government, its agencies, or its sponsored enterprises. The RMBS' underlying assets, residential mortgages loans, are also more sensitive to macro-economic

---

<sup>22</sup> Kamakura Report, p. 10.

factors than other investments available to corporate credit unions. In fact, of the current combined losses at Western Corporate Federal Credit Union (WesCorp) and U.S. Central Federal Credit Union (U.S. Central), over 95 percent were related to private label RMBS. NPCUs also invest directly in residential mortgages, and by prohibiting corporates from purchasing private label RMBS, the pro-cyclical nature of corporate and NPCU balance sheets is also diminished. Given the lack of a guarantee, the sensitivity of mortgages to macro-economic factors, the concentration of mortgages on the balance sheets of natural person credit unions, and the recent history of corporate investments, the NCUA Board believes a prohibition on private label RMBS is warranted.

#### 704.2 Definition of private label security

The final rule defines private label security as “a security that is not issued or guaranteed by the U.S. government, its agencies, or its government-sponsored enterprises (GSEs).”

#### 704.2 Definition of residential mortgage-backed security

One commenter noted that while the proposed rule defined the terms “residential property” and “residential mortgage backed security,” the proposed definition of RMBS did not include the use of the phrase “residential property.” The Board agrees that, for precision, the RMBS definition should refer to “residential property,” and the final rule now defines RMBS as “a mortgage-backed security collateralized primarily by mortgage loans on residential properties.” Also, as a point of clarification, this 704.2 definition of RMBS includes not only securities primarily backed by first lien residential mortgages, but also securities primarily backed by other-than-first-lien residential mortgages, such as home equity loans.

#### 704.5(h)(8) Prohibiting subordinated securities

The Board has also added a new paragraph 704.5(h)(8) to the final rule prohibiting investment in subordinated securities. Subordinated securities present greater credit risk, liquidity risk, and price volatility than more senior securities. Losses on subordinated securities may at times reach 100 percent of principal, even when a more senior security in the same issuance may only lose pennies on the dollar. In fact, over 48 percent of the current combined losses incurred by WesCorp and U.S. Central are attributable to subordinated securities, mostly subordinated RMBS.

#### 704.2 Definition of subordinated security

The proposal defined subordinated security in §704.2 as

[a] security that has a junior claim on the underlying collateral or assets to other securities in the same issuance. If a security is junior only to money market fund eligible securities in the same issuance, the former security is not subordinated for purposes of this definition.

The final rule retains this definition, but adds the words “at the time of purchase” because a subordinated security can lose its subordination as the more senior tranches are paid down. The final rule also moves the existing prohibition on purchasing stripped MBS from paragraph (h)(7) to (h)(9).

The relationship between the other investment, credit risk, and ALM prohibitions, and these two 704.5(h) prohibitions on private label RMBS and subordinated securities, is discussed in more detail below.

Accordingly, and except as described above, the Board adopts the final §704.5, and associated definitions, as proposed.

#### **704.6 Credit risk management**

The proposed §704.6 included tighter single obligor limits and new sector concentration limits. The proposal also required that all corporate investments, other than in another corporate or CUSO, have a minimum credit rating from all publically available NRSROs of no lower than AA- for long term ratings and A-1 for short term ratings. Additionally, 90 percent of corporate investments must have at least two NRSRO ratings.

Several commenters thought the proposed tightening of the existing single obligor limits, and establishing of new sector limits, was a positive change, and some asked for even tighter restrictions. On the other hand, several commenters thought the proposed limits were too tight and may increase risk and limit the corporates' ability to manage their businesses and balance sheets efficiently. The Board agrees that some of the proposed limits should be tightened and others relaxed, as discussed below.

##### 704.6(a) Policies

The proposal did not contain any amendments to this paragraph.

704.6(b) Exemptions.

The proposed paragraph 704.6(b) exempted certain assets from both the sector concentration limits and the single obligor concentration limit, including fixed assets, loans, investments in CUSOs, investments issued by the United States or its agencies or its government sponsored enterprises, and investments fully guaranteed or insured as to principal and interest by the United States or its agencies.

Several commenters believed settlement funds should also be exempt. These commenters were concerned that the tight single obligor limit would force corporates to find many additional settlement counterparties given the proposed tighter limit of 25 percent of capital per obligor. The commenters were particularly concerned about seasonal patterns that cause settlement activity to fluctuate throughout the year and could potentially cause violations of the single obligor limits.

The Board agrees with these concerns, and has added settlement funds in federally insured depository institutions to the list of exempt investments in the final 704.6(b). The Board has also added a definition of settlement funds to the final §704.2 to read as follows:

Settlement funds means any funds in a deposit account used to discharge obligations of the corporate credit union with respect to payment orders.

Corporates must take care to properly classify settlement funds and not include non-settlement short-term investments in this category. Generally, the characteristics of settlement funds are: 1) Funds are used for immediate-value transactions (transactions that must be paid for immediately to be processed or have a particular value at the time of processing); 2) Funds are used to settle transactions from institutions such as clearing houses, banks, payment processors, and other credit unions; and 3) Funds are used for same-day settlement accounts, or in the case of automated clearing house transactions within a few days. The amount of money a corporate classifies as "settlement funds" at a third party for purposes of exclusion from the 704.6 single obligor limit should also be no more than the third party requires under the terms of its settlement policies.

The proposed 704.6(b) had a complete exemption for agency MBS, but the Board has instead determined not to exempt such MBS. Rather, the Board intends to permit investment in MBS, including agency MBS, subject to concentration limits described below. Accordingly, the final rule amends the 704.6(b) exemption for “investments that are issued or fully guaranteed as to principal and interest by the U.S. government or its agencies or its sponsored enterprises” by adding the words “other than mortgage backed-securities” at the end. Also, the reference to subordinated securities is eliminated from the final rule since such securities will be prohibited.

704.6(c) – Issuer concentration limits.

The proposed 704.6(c) tightens the single obligor limits to 25 percent of capital, subject to certain enumerated exceptions.

In addition to the enumerated exceptions, many commenters felt short-term investments, such as federal funds, should have either a relaxed single obligor limit, or be exempt from the single obligor limit, due to the lower risk associated with these transactions. The Board agrees. Investments of shorter maturity present less credit risk, all else being equal. Still, it is not appropriate to exempt these short term investments from some limit, as these obligations (including federal funds) do have some credit risk. Accordingly, the Board adds a new paragraph (c)(2)(i) to the final rule limiting investments in one obligor to 50 percent of capital where the remaining maturity of all obligations with that obligor are less than 30 days.

In general, the obligor in a securitization situation will be the Qualified Special Purpose Entity (QSPE) trust that issues the securities. Some commenters were concerned that there were very few potential obligors in the credit card ABS sector, particularly given the prevalence of “master” QSPE trusts, and so the single obligor limitation could keep corporates from making any significant investments in the credit card ABS sector. Accordingly, the final rule adds a new paragraph 704.6(c)(2)(ii) to the final rule relaxing the single obligor limitation for credit card master trusts to 50 percent of capital. The Board observes that credit card ABS, both as a sector and as individual securities, have withstood both systemic and issuer shocks since these ABS were first issued. Given the sector’s relative safety and the limited number of potential counterparties, NCUA believes a 50 percent obligor limitation for these master trusts is appropriate.

704.2 Definition of obligor.

The final rule amends this definition to clarify that, for purposes of securities issued out of a trust, such as a Qualified Special Purpose Entity (QSPE) trust, the trust itself is the obligor.

704.6(d) Sector concentration limits.

NCUA proposed, as part of its sector concentration limits, that private label RMBS be limited to the lower of 500 percent of capital or 50 percent of assets. Some commenters, and Kamakura, were concerned that these limits were not tight enough. Kamakura recommended tighter limits for both commercial mortgage-backed securities (CMBS) and private label RMBS and a combined limit for the MBS sectors due to the higher correlation of mortgages to macro-economic factors.<sup>23</sup> Kamakura recommended a sector limit of 15 percent of the portfolio each for both CMBS and private label RMBS, and a combined sector limit of 25 percent of the portfolio. As discussed earlier, the final rule prohibits private label residential MBS. The Board also agrees a tighter limit for the CMBS sector is appropriate. Additionally, the Board believes an overall restriction on the amount of MBS, including agency MBS, is appropriate due to the additive nature of the corporates' concentration exposure when considered along with NPCU mortgage exposure.

Accordingly, the Board amended the final paragraph (d)(1)(i) to limit all MBS, inclusive of commercial mortgage-backed securities, to the lower of 1000 percent of capital or 50 percent of assets. Additionally, the final rule revises paragraph (d)(1)(ii) to tighten the limit on CMBS to the lower of 300 percent of capital or 15 percent of assets.

Paragraphs (d)(1) and (d)(2) establish sector concentration limits for specified investment types, and paragraph (d)(3) establishes a general, aggregate limit of 100 percent of capital or 5 percent of assets for any other investment type not described in (d)(1) or (d)(2). Some commenters were concerned that investments in federal funds might be included in the (d)(3) limit since fed funds were not specifically enumerated in the other sectors and were not generally exempt under 704.6(b). The Board recognizes that corporate credit unions need flexibility to engage in short-term investments and agrees that federal funds transactions with federally insured depository institutions should be explicitly excluded from the sector concentration limits in a manner similar to deposits in

---

<sup>23</sup> Kamakura Report, p. 10.

those institutions. Accordingly, the final rule amends paragraph (d)(4) to explicitly exclude federal funds investments in other federally insured depository institutions from sector concentration limits.

704.6(e) Corporate debt obligation subsector limits.

The proposed paragraph 704.6(e) set out concentration limits for subordinated securities. Since the final 704.5(h) outright prohibits subordinated securities, the proposed text is no longer necessary and has been deleted from the final rule and replaced with a different provision, as discussed below.

The proposed 704.6(d)(1)(viii) limited corporate debt obligations to the lower of 1000 percent of capital or 50 percent of assets. Some commenters, including some trade associations, thought these limits were not restrictive enough. Some of these commenters recommended that NCUA further restrict concentrations in corporate debt by industry. The NCUA Board agrees. The final rule replaces the proposed 704.6(e) with a new 704.6(e) establishing subsector limits for corporate debt obligations. The final rule limits corporate debt to the lower of 200 percent of capital or 10 percent of assets for each of the 20 North American Industry Classification System (NAICS) industry sectors. The 20 NAICS sectors are listed in the following table:

<b>Code</b>	<b>Industry Classification</b>	<b>Code</b>	<b>Industry Classification</b>
11	Agriculture, Forestry, Fishing and Hunting	53	Real Estate and Rental and Leasing
21	Mining, Quarrying, and Oil and Gas Extraction	54	Professional, Scientific, and Technical Services
22	Utilities	55	Management of Companies and Enterprises
23	Construction	56	Administrative and Support and Waste Management and Remediation Services
31 – 33	Manufacturing	61	Educational Services
42	Wholesale Trade	62	Health Care and Social Assistance
44 - 45	Retail Trade	71	Arts, Entertainment, and Recreation
48 – 49	Transportation and Warehousing	72	Accommodation and Food Services
51	Information	81	Other Services (except Public Administration)
52	Finance and Insurance	92	Public Administration

These subsector limits will ensure more diversification in corporate debt obligations and reduce correlation risk due to excessive concentrations in any single subsector, particularly the finance subsector.

704.6(f) Credit ratings.

As discussed above, the proposed paragraph 704.6(f) required that corporates consult all publicly available NRSRO ratings and use those ratings to screen potential investments.

Several commenters and Kamakura expressed concerns regarding reliance on credit ratings provided by NRSROs. Kamakura recommended corporates not look to NRSRO ratings and instead implement a macro economic analysis approach to evaluating credit risk and conduct their own internal analysis on the probability of default of any given securities.<sup>24</sup> The current 704.6(a), which NCUA did not amend in this rulemaking, requires that a corporate adopt a credit risk policy and evaluate the credit risk of individual securities. Still, the Board disagrees with the idea that NRSRO ratings have no value and that they should be entirely ignored when conducting credit analysis on a particular security. NRSRO ratings are useful tools when used, as in the proposed 704.6(f), only to *exclude*, not *include*, securities as potential corporate investments. Corporates must do additional credit analysis on each security that passes the initial NRSRO ratings screen, and each security that passes the NRSRO screen must comply with each and every one of the other investment, credit risk, and ALM provisions of this final rule.

704.6(g) Reporting and documentation

The proposal did not contain any amendments to this paragraph. Accordingly, and except as described above, the Board adopts the final §704.6 as proposed.

**704.8 Asset and liability management (ALM)**

The proposed §704.8 contained several new ALM provisions, including a modification to the provision on early withdrawal penalties, two cash flow mismatches limits, a new 2 year limit on the WAL of a corporate's assets, and a requirement to measure net interest income. Some commenters were in favor of

---

<sup>24</sup> Kamakura report, pp. 8 – 10.

the revisions in the proposed rule. Many commenters, however, objected to different provisions within the proposed rule, generally complaining about the complexity and efficacy of the multi-level testing in proposed paragraphs 704.8(e), (f), and (g). As discussed below, the Board has made several changes from the proposed §704.8 to the final.

704.8(a) Policies.

Proposed paragraph 704.8(a)(6) contained a conforming change to reference the two proposed cash flow mismatch sensitivity tests. Because, as discussed below, these tests are not adopted in the final rule, the conforming amendment has been removed from paragraph (a)(6).

704.8(b) Asset and liability management committee (ALCO).

The proposal did not contain any amendments to this paragraph.

704.8(c) Penalty for early withdrawals.

The proposal limited a corporate's ability to pay a market-based redemption price to no more than its book value, thus eliminating the corporate's ability to pay a premium on early withdrawals. Hundreds of commenters objected to this prohibition, arguing that the proposed prohibition on premiums would make corporates less competitive with their certificates, and thus reduce corporate liquidity on the front-end. The NCUA Board agrees now that prohibiting a premium is not likely to protect the corporate's liquidity, and could interfere with the corporate's competitiveness, and so the Board determined not to adopt the final 704.8(c) as proposed. Instead, paragraph 704.8(c) will remain as in the current rule. Some comments also indicated that all corporates are not applying the current rule correctly. For example, the Board noted a corporate may base its market-based penalty on the asset values the certificate is matched against, and so the redemption value would decline as the value of the underlying assets decline. This methodology violates the current regulation's requirement that penalties be based on the cost of replacing the lost funds.

The following example illustrates the application of the rule in a premium situation.

Assume a corporate is offering 2-year certificates at a 2 percent coupon, and 1-year certificates at a 1.5 percent coupon, and that the corporate then issues a 2-year certificate to "NPCU A." One year later, assume NPCU A wishes to

redeem the certificate and that interest rates have dropped, so that the corporate is now issuing 1-year certificates at 1 percent. That would make the replacement cost of the original certificate approximately 100 basis points (BP) (assuming the corporate can immediately issue a new certificate), but the dividend rate on the original certificate is more than that, at 200 BP. So the net savings for the corporate because of the early redemption is 100 BP. NCUA would then expect the corporate, at a minimum, to redeem this certificate at a premium of nearly 100 BP, but subtract some penalty spread to account for the uncertainty, and expense, in actually issuing a replacement certificate. Using this methodology and a penalty spread of, say, 25 BP, the 2-year certificate will be redeemed at an approximate price of 100.75. The market-based penalty, then, would technically be 25 BP, which reduced the 100 BP premium to 75 BP.

704.8(d) Interest rate sensitivity analysis.

The proposal did not contain any specific amendments to this paragraph. However, the final rule clarifies that for interest rate risk (IRR) tests conducted “at least quarterly,” at least one of the tests must be conducted on the last day of the calendar quarter. Traditionally, the last day of the quarter has been used by the corporates, and this clarification ensures consistency in measurement periods. Additionally, if “at least monthly” testing is required because NEV ratio falls below three percent, the last day of the month must also be one of the testing dates.

(Proposed) 704.8(e) – Cash flow mismatch sensitivity analysis.

See discussion in next paragraph.

(Proposed) 704.8(f) Cash flow mismatch sensitivity analysis with 50 percent slowdown in prepayment speeds.

The proposal established new limits on cash flow mismatch sensitivity tests. Although the proposed tests were structured in terms of the effect on NEV of an immediate 300 basis point increase in the yield demanded by investors, the effect of the proposal was to ensure that the gap between the average life of a corporate’s assets and its liabilities would remain within a few months and so not present extensive liquidity and market risk to the corporate.

Many commenters thought the two proposed cash flow mismatch sensitivity tests were too restrictive. Other commenters thought these tests were too complicated. Some commenters did not understand the tests were measuring the risk associated with cash flow mismatches, and these commenters discussed

spread widening based on historical averages for such widening. Kamakura recommended eliminating the paragraph (e) and (f) stress tests, stating that these tests pose a potential burden on corporate credit unions, greatly reduce the number of securities available for investment, and do not appear to identify securities with differences in credit performance meaningfully related to the performance of securities throughout the credit crisis.

The Board generally concurs with these commenters and Kamakura, and the two proposed cash flow mismatch tests have been removed from the final rule. The elimination of these two tests will allow corporates to have a larger mismatch between asset and liability cash flows, which increases earnings potential but also increases credit and liquidity risk. To mitigate this increased risk, the NCUA Board has retained the proposed 2-year WAL on assets and added an asset WAL extension test as discussed below.

*(Proposed) 704.8(g), (Final) 704.8(e) Net interest income modeling.*

In addition to this NEV testing, the proposal required every corporate conduct net interest income (NII) modeling. The Board did not receive any significant comments on this provision, other than ones stating that corporates already did this modeling as a matter of policy. The final rule amends the timing of the modeling to read “be performed at least quarterly, including once on the last day of the calendar quarter.” As discussed above, this change ensures consistency in the modeling results. This paragraph is also renumbered as paragraph 704.8(e) in the final.

*(Proposed) 704.8(h), (Final) 704.8(f) Weighted average asset life.*

The proposal prohibited the weighted average life (WAL) of a corporate’s loans and investment portfolio, excluding derivatives and equity investments (e.g., investments with indefinite maturities such as PIC and CUSO investments), from exceeding two years.

The primary purpose of this restriction in the proposal was to ensure that a corporate did not artificially inflate the WAL of its liabilities so as to get around the asset – liability cash flow mismatch limits. Many commenters objected to the 2-year asset WAL restriction.

Some of these commenters were concerned that the 2-year WAL restriction would prevent corporates from providing long term liquidity loans to NPCUs. Loans over two years in maturity are not generally liquidity loans – they are loans

used for term balance sheet funding to match off against longer-term loans or to fund portfolio growth. Since a corporate's primary role in lending is as a liquidity provider of short-term loans, NPCUs cannot rely on corporates to provide term lending in significant amounts. NPCUs have other viable options for longer-term funding such as the Federal Home Loan Bank system, which provides both fixed rate and variable rate lending.

With the elimination of the cash flow mismatch tests in proposed paragraphs 704.8(e) and 704.8(f), the NCUA Board believes it is very important to retain the proposed 2-year WAL restriction on the investment portfolio. This 2-year limit forces corporates to accommodate to the fact that corporates are, first and foremost, providers of payment systems, which, in turn, requires some matching of the investment portfolio to the short term payment liabilities to ensure liquidity for the payments system. Providing liquidity to NPCUs, particularly long-term liquidity, is of secondary importance to this payment systems function.<sup>25</sup> Still, the 2-year WAL restriction is a portfolio-wide restriction, and the WAL restriction will allow corporates to make limited amounts of term loans exceeding two years in maturity if those loans are matched by other corporate assets of less than two year maturities.

Some of the commenters thought the 2-year asset WAL would prevent a corporate from being able to earn sufficient spread to build retained earnings in a timely manner. As discussed in more detail below in connection with some hypothetical corporate portfolios, the Board does not believe this is true. In fact, as suggested in the Kamakura report, the proposed cash flow mismatch tests were in most cases the determining factor in limiting a corporate's ability to populate its investment portfolio with ABS and MBS that generated higher yields for the corporate. Under the proposed 704.8(e) cash flow mismatch test, and assuming a 4 percent NEV, a corporate's asset WAL could not exceed its liability WAL by more than about 3 months without violating proposed 704.8(e). That meant that if the WAL of the corporate's liabilities was about 8 months -- which is about the current average for corporates -- then the corporate's asset WAL could only be about 11 months. Since the final rule will not contain the proposed cash flow mismatch tests, this corporate can take its asset WAL all the way out from 11 months to 2 years, generating more earning power (assuming an upward sloping yield curve). NCUA expects the WAL of a corporates' liabilities to remain

---

<sup>25</sup> Providing investments on a principal basis will be even less of a priority in the corporate business model going forward.

relatively short going forward going as they focus on the payment systems function. Accordingly, the elimination of the cash flow mismatch tests will have an even greater positive impact on corporates' ability to maintain longer assets and generate earnings from such assets<sup>26</sup>.

The proposal required that a corporate assume, when calculating the WAL, that no issuer options will be exercised. For example, the corporate cannot assume that an issuer will execute a clean-up call. The final rule also requires that the corporate not assume that any market options will be exercised. This requirement addresses the failure of auction rate securities. During the credit crisis, auction rate securities, initially considered by some to have a maturity of approximately one month, extended out in some cases to 15 or 20 years when the auction failed.

The final rule also provides that if the WAL of a corporate credit union's investment portfolio exceeds two years on the testing date, this WAL must be measured more frequently. In that case the measurement must be taken at least monthly, including once on the last day of the month, until the WAL is once again below two years.

With the elimination of the cash flow mismatch tests in paragraphs 704.8(e) and 704.8(f), the proposed WAL limit has been renumbered in the final rule from 704.8(h) to 704.8(f).

#### 704.2 Definition of weighted average life.

The current §704.2 provides that:

Weighted average life means the weighted-average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of principal.

Although stripped MBS are generally impermissible for corporates, it is possible that a corporate might hold some sort of stripped interest only (IO) security. Accordingly, the Board amends the final definition of weighted average life to provide for IO securities that have no principal return:

---

<sup>26</sup> Though a corporate is still bound by the IRR NEV constraints in paragraph 704.8(d).

The calculation of weighted average life for interest only securities means the weighted-average time to the return of a dollar of interest, calculated by multiplying each portion of interest received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of interest to be received.

*(Final) 704.8(g) – Weighted average life with 50 percent slowdown in prepayment speeds.*

As discussed above, the Board's decision to forgo the proposed cash flow sensitivity tests increases the importance of the proposed 2-year asset WAL in protecting the payment systems from excessive risk. In addition to the 2-year WAL restriction, and to protect against extension risk, the Board has added a new paragraph 704.8(g) to the final rule limiting asset WAL extension to 2.25 years assuming a 50 percent slowdown in prepayment speeds, regardless of asset type.

In the past, many market participants believed that lower interest rates would create faster prepayment speeds in residential MBS. During the recent credit crisis, however, prepayment speeds slowed substantially in many RMBS, even with lower interest rates. In some cases, a prepayment slowdown can produce radical increases in the WAL of a security (e.g., in excess of one thousand percent), particularly in support tranches. Accordingly, this new 50 percent slowdown test limits the extension risk, and the related credit and liquidity risk, that a corporate can accept into its portfolio. This new 704.8(g) WAL test with prepayment slowdown is similar to the proposed 704.8(f) cash flow mismatch sensitivity test with prepayment slowdown that the Board is not adopting, except that this new 704.8(g) is simpler to calculate and not as restrictive as the proposed 704.8(f).

*704.8(h) Government issued and guaranteed securities.*

Many commenters thought securities that are issued or fully guaranteed as to principal and interest by the U.S. government or its agencies or its sponsored enterprises should be exempt from the cash flow mismatch and 2-year WAL restrictions. The most common argument was the absence of credit risk in these securities.

The Board is sympathetic to this concern, and so the final rule allows the WAL of securities that are issued by, or fully guaranteed as to principal and interest by, the U.S. government or its agencies or its sponsored enterprises to be multiplied by a factor of 0.50 when determining the WAL of a corporate's entire portfolio. So, for example, a 4-year WAL agency security will be treated as if it has a 2-year WAL for purposes of the WAL calculations in paragraph 704.8(f) and (g). The Board also considered exempting government securities from both the asset WAL tests, but concluded that such an exemption was not appropriate because these securities do have some market volatility.

The Board determined to use the 0.50 factor because it provides corporate credit unions with a material measure of relief from the WAL calculation without creating undue market risk. Small factors, such as 0.25, would not provide a significant benefit to the corporates, while larger factors, such as 0.75, raised concerns over market risk and the potential negative effects on NEV. During the global credit crisis, even agency RMBS spreads widened significantly between October 2008 and November 2008. During this period, spreads between the Bloomberg generic 5-year Fannie Mae Benchmark and the swap curve widened by 111 BP, introducing significant market risk on these securities. Other Bloomberg generic indices also widened significantly, with the longer term benchmarks widening even more. The Board believes the 0.50 factor provides the best balance between WAL relief and ensuring that corporate NEV positions are protected.

704.8(i) Effective and spread durations.

The proposed paragraph 704.8(i) required a corporate measure at least once a quarter, the effective duration and spread durations of each of its assets and liabilities, where the values of these are affected by changes in interest rates or credit spreads. There was no significant comment on this provision. The Board determined to clarify the timing of the tests by inserting the phrase "including once on the last day of the calendar quarter." Otherwise, this paragraph was finalized as proposed.

704.8(j) Regulatory violations.

The proposed paragraph 704.8(j) required that a corporate take action to report, and cure, violations of §704.8. The proposal also stated that if the corporate could not timely cure the violation, the corporate would suffer a PCA downgrade.

One commenter thought it inappropriate to tie the failure of ALM tests to PCA downgrades. The Board disagrees. A corporate must maintain its NEV levels, and protect those NEV levels from credit, extension, and liquidity risk. A PCA downgrade, and the associated PCA provisions in §704.4, give the Board the necessary tools to deal with a corporate's failure to meet important regulatory requirements.

704.8(k) Overall limit on business generated from individual credit unions.

The proposed paragraph 704.8(k) prohibited a corporate from accepting from a member or nonmember credit union or other entity any investment, including shares, loans, PCC, or NCAs if, following that investment, the aggregate of all investments from that member or entity in the corporate would exceed 10 percent of the corporate credit union's moving daily average net assets.

Hundreds of commenters opposed this limit on business from individual entities. Some commenters believed, for example, that this restriction would prevent a corporate from certain borrowings, such as liquidity borrowings from sources like the Federal Home Loan Banks. This was not the Board's intent. Accordingly, the final 704.8(k) applies the limit only to member and nonmember credit unions. The Board has also increased the limit in the final rule from 10 percent of a corporate credit union's moving daily average net assets to 15 percent. This increase in the limit is appropriate because of seasonal factors that affect the amounts of settlement funds a NPCU may have with a corporate. The Board believes, however, that increasing the limit beyond 15 percent is not appropriate and could lead to excessive concentrations of risk with one or two members.

The final 704.8(k) will not become effective for 30 months following the date the final rule is published in the federal register.

Accordingly, and except as described above, the Board adopts the final §704.8, and associated definitions, as proposed.

## **704.9 Liquidity management**

704.9(a) General.

The proposed paragraph (a)(3) required a corporate maintain sufficient sources of cash and cash equivalents to support its payment system obligations. There was no significant comment on this proposal, and it is adopted into the final rule.

### 704.9(b) Borrowing limits

The proposed paragraph 704.9(b) replaced the current borrowing limits of up to the greater of 10 times capital or 50 percent of shares (excluding shares created by the use of member reverse repurchase agreements) and capital, with a limit of the lower of 10 times capital or 50 percent of capital and shares on aggregate borrowing. The proposal also added a new sublimit on secured borrowing, as discussed below.

#### 704.9(b)(1) Secured borrowings.

The proposal permitted a corporate to borrow on a secured basis, but, generally, only for liquidity purposes and only with a maximum maturity of 30 days. A corporate may also borrow on a secured basis for non-liquidity purposes, but only if the corporate is well-capitalized and only in an amount equal to the corporate's excess capital.

Several commenters felt current borrowing limits were sufficient while others felt their corporates should have no borrowing limits. These latter commenters argued the risks associated with borrowing would be captured by asset liability management modeling. Dozens of commenters also felt the 30 day limit on secured borrowings established by §704.9(b)(1) was too restrictive and would reduce a corporate's ability to offer lending products and interest rate swaps to natural person credit unions. Many commenters stated any negative ramifications of borrowing in excess of 30 days would be constrained by other aspects of the proposed rule. Many commenters felt §704.9(b)(1) should be eliminated all together.

The Board believes the proposed borrowing limits are prudent and sufficient to allow corporate credit unions to manage liquidity needs and to safeguard their payment systems. The Board also still believes that corporates should be limited in their ability to borrow on a secured basis for other than liquidity purposes. As demonstrated by recent events, secured borrowing can create additional risks for the corporate and the NCUSIF. Secured lenders require collateral to be valued at market and they impose an additional haircut (margin) to ensure the borrowing is fully and continuously collateralized. Market shocks can create short-term market values that are significantly below long-term intrinsic values and which can magnify potential losses if the creditor seized the collateral and sold it as permitted by the lending agreements.

Accordingly, the final rule retains restrictions on secured borrowing for non-liquidity purposes and retains the 30 day maximum term for secured borrowings made for liquidity purposes. These restrictions will not preclude a corporate from renewing liquidity-related borrowings on a rolling basis. These limits on aggregate borrowing and secured borrowing should help mitigate the consequences of future adverse market events for the corporates and the NCUSIF.

As with most of these final revisions, the effective date of the paragraph 704.9(b) revisions will be [INSERT DATE 90 DAYS FOLLOWING DATE OF PUBLICATION IN FEDERAL REGISTER]. NCUA expects that corporates will not enter into any new borrowings before that date that will put them out of compliance with 704.9(b) on that date. Also, to the extent the a corporate has one or more borrowings on that date that are not in compliance with the requirements of 704.9(b), NCUA will expect the corporate to move aggressively to pay off those borrowings or to replace them with borrowings that comply with 704.9(b).

Accordingly, and except as described above, the Board adopts the final §704.9 as proposed.

## **Appendix B to Part 704 – Expanded Authorities and Requirements**

The proposed rule revised the qualification criteria, and elements of, the Base-plus and Part I authority, and eliminated the current Part II authority, in Appendix B.

### General

The final rule includes this new language:

A state chartered corporate credit union may not exercise any expanded authority that exceeds the powers and authorities provided for under its state laws. Accordingly, requests by state-chartered corporate credit unions for expansions under this part must be approved by the state regulator before being submitted to NCUA.

This requirement is consistent with §704.1(b). 12 CFR 704.1(b).

### Base Plus

The final Base-Plus section removes the references to the proposed cash flow sensitivity tests in §704.8(e)(1) and §704.8(f)(1) since these two proposed tests do not appear in the final rule. Language has also been added to clarify that for monthly NEV testing, the last day of the month must also be one of the testing dates.

### Part I

To qualify for Part I authority, the proposal added a requirement that a corporate achieve and maintain a leverage ratio of at least 6 percent, meaning that its Tier 1 capital, divided by its moving DANA, must equal or exceed 6 percent. The proposal also limited the aggregate amount of investments purchased under Part I authorities to the lower of 500 percent of capital or 25 percent of a corporate credit union's assets. NCUA did not receive any significant comment on these proposals, and they are retained in the final Part I. The final Part I removes the references to the proposed cash flow sensitivity tests in §704.8(e)(1) and §704.8(f)(1) since these two proposed tests do not appear in the final rule.

### Part II

The proposal removed the current Part II, which generally permitted investments down to BBB, and renumbered the existing Part III, on foreign investments, as Part II.

NCUA did not receive any significant comment on the removal of the current Part II, and it is removed and replaced in the final rule with the Part on foreign investments.

The proposed Part II on foreign investments established credit exposure limits for any single foreign obligor not to exceed 50 percent of capital. The NCUA Board intended this limit to be consistent with the single obligor limits established by the proposed and final §704.6(c). Accordingly, the final paragraph (a)(4) of Part II is amended to limit exposure to a single foreign obligor to the greater of 25 percent of capital or \$5 million.

### Part III

The proposal renumbered the current Part IV, which permits limited investments in derivative transactions, to Part III.

Paragraph (a) Permissible purposes for derivatives.

The proposal modified the current authority in paragraph (a) to ensure that corporates do not use derivatives to take on additional risk. Proposed paragraph (a) permits the use of derivatives only to create structured products, mitigate interest rate and credit risk on its own balance sheet, or to hedge the balance sheet of its members. NCUA received no significant comment on this proposal, and the final paragraph (a) is adopted as proposed.

Paragraph (b) Credit ratings of derivatives counterparties.

The proposed paragraph (b)(1)(i) limited corporates to derivative counterparties rated no lower than the minimum permissible rating for comparable permissible term investments. Some commenters were concerned with the lack of AA- rated counterparties for corporates without Part I Expanded Authority. These commenters argued this AA- rating restriction would keep corporates from finding an adequate number of qualifying derivative counterparties. Some commenters also cited the netting and collateral posting required in derivative transactions, noting these requirements mitigate the credit risk of a derivative transaction in comparison to a similarly rated investment transaction.

The Board concurs there are few potential derivatives counterparties rated AA- or higher. In fact, there are many more potential derivatives counterparties rated A or A-, and a corporate that wants to engage in derivatives activity needs access to counterparties rated A or A-. The Board believes the credit quality of derivative counterparties is not as important as the credit quality of investment issuers. The nature of derivative transactions the corporates generally make (e.g., interest rate swaps) make them less risky than traditional investments, given the relatively low exposure levels and the mitigation of credit risk associated with bilateral netting agreements and collateral requirements.

Accordingly, the final paragraphs (b)(1)(i) and (ii) permit corporates that qualify for Part III derivatives authority to engage in derivatives transactions with domestic counterparties rated no lower than A-, and, if the corporate has Part II Expanded Authorities, with foreign counterparties rated no lower than permissible under that Part II. The final paragraph (b)(1)(iv) also requires the corporate comply with the Investment Action Plan provisions of §704.10 if any rating relied upon to meet the requirements of paragraphs (b)(1)(i) or (ii) is downgraded below the minimum rating requirements.

In addition, the Board notes that OCCU publishes separately from Part 704 the specific criteria to qualify for any particular expanded authority. NCUA will publish the parameters for Part III qualification, which parameters will include compliance with industry best practices on bilateral netting of derivatives and the posting of collateral.

#### Part IV

The proposal renumbered the current Part V authority on participation lending as Part IV. The final rule reflects this renumbering.

Accordingly, and except as described above, the Board adopts the final Appendix B as proposed.

### **§ 704.11 Corporate Credit Union Service Organizations (CUSOs).**

#### 704.11(e) Permissible activities.

The current 704.11(e), entitled prohibited activities, prohibits a CUSO from acquiring control, directly or indirectly, of another depository financial institution or to invest in shares, stocks, or obligations of an insurance company, trade association, liquidity facility, or similar organization.

The proposal would move the current prohibition language in 704.11(e) to proposed paragraph 704.11(g)(4) and replace the current 704.11(e) with a new paragraph entitled permissible activities. The new proposed 704.11(e) would require that a corporate CUSO agree to limit its activities to brokerage activities, investment advisory services, or other categories of activities (including but not limited to service activities) as approved in writing by the NCUA and published on the NCUA website.

Several commenters generally agreed with the proposed regulation of CUSO activities and enhancement of CUSO transparency. Some of these commenters are concerned about the migration of activities from corporates to CUSOs and increased corporate exposure to CUSO risks.

Many commenters, however, objected to the proposal that NCUA preapprove and publish a listing of approved corporate CUSO activities. Some objected to

such NCUA preapproval generally, while others felt that publishing the list separate and apart from the rule created too much ambiguity in the rule and would inhibit proper corporate planning. Those commenters that objected categorically to NCUA preapproval felt such a preapproval requirement would discourage corporate ownership of CUSOs, and that such ownership was important because corporates bring a level of expertise to CUSO management that NPCUs may not bring. One of these commenters stated that NCUA should continue the approach of delineating those activities that are prohibited, not those that are approved. Another commenter believes that NCUA should not place limits on corporate CUSOs at this time because the most recent corporate crisis was an investment issue not related to CUSOs.

The Board believes that NCUA must have some oversight over corporate CUSOs. These CUSOs affect not only the health of the corporates, but also the health of the credit union system as a whole, because many corporate CUSOs serve NPCUs directly. The Board is concerned that some activities might migrate from corporates to CUSOs as a result of this rulemaking, and NCUA needs to understand and preapprove the activities of these CUSOs and have access to these CUSOs. In addition, the Board reiterates that it is not regulating just in reaction to the immediate past crisis, but also attempting to anticipate future problems and construct a regulatory scheme that will help NCUA deal with those problems when they arise.

One commenter wanted to know why NCUA had only identified two activities (brokerage and investment advisory services) as preapproved in the rule text, and stated that only one of its four existing CUSOs would prequalify under these approved activities. This commenter stated that another activity, “item processing,” which was very important to its members, had been moved from the corporate to a CUSO to separate the “operational risk” from the corporate, and this commenter wanted a lengthier list of preapproved activities in the rule, including item processing. Two commenters suggested NCUA should expand the list of preapproved activities in the regulation to include item processing, shared data processing, and “shared services.” This commenter and others also stated that the rule should outline the process and criteria for approving each new category and explain the criteria. Other commenters asked that the approved list include business lending services, ALM services, card services, and the programs for the purchase of CDs from other depository institutions. One commenter stated that data processing should be preapproved. A few

commenters stated that the corporate rule should include the same list of preapproved CUSO activities as currently exists for federal credit union CUSOs in Part 712 of NCUA's rules. One said that, at a minimum, NCUA should incorporate into Part 704 all the activities described in 712.5(a), (b), (e), (g), and (k).

The Board preapproved brokerage and investment advisor services because the Board believes providing those services are very appropriate corporate CUSO activities. The Board does not believe that all the preapproved categories of activities in §712.5 for natural person federal credit union CUSOs are necessarily appropriate for corporate CUSOs, and so declines to incorporate §712.5 language into 704.11(e). In fact, at this time, the Board will not be adding additional preapproved activities into the rule text of 704.11(e). Corporate CUSOs may submit descriptions of the activities they currently perform, or desire to perform, to NCUA beginning immediately on publication of this rule, and NCUA will begin the review and approval process for those activities. The Board wants to examine each activity, whether new to corporate CUSOs or a preexisting activity.

One commenter suggested that a corporate submit a business case when seeking approval for a service rather than limit, upfront, the kinds of activities permissible. This commenter noted that the credit union system needs to have the flexibility to grasp opportunities as they arise. Some commenters objected to the informal nature of the NCUA approval process and wanted additional definitions and information in the rule text.

In fact, the Board's intent with the proposed, informal approval process is to streamline that process and to ensure that appropriate activities are approved as quickly as possible. Once NCUA has approved and published an activity category, any corporate CUSO may engage in that activity without further approval. The Board intends this process to be flexible enough to accommodate opportunities as they arise, without creating too much risk to the credit union system. On the other hand, the Board understand that corporates and their CUSOs need certainty, and some sort of permanence to the category or approved activities. The Board does not want corporates or their CUSOs to be concerned that NCUA might use the informal process to remove or radically alter a category of approved activities after NCUA's publication of that approval. Accordingly, the final rule adds a new paragraph (e)(3) that provides NCUA will not remove a particular activity from the approved list, or make substantial

changes to the content or description of that approved activity, except through the formal rulemaking process.

One commenter was concerned about potential service disruptions as existing CUSOs go about obtaining NCUA approval. Some commenters stated that corporates would need a transition period following publication of the final rule to determine if their current corporates were engaged in activities acceptable to NCUA, with one suggesting 180 days. Another commenter thought NCUA should publish a list of approved activities in advance of the final rule, and another stated that there should be a “fast track” approval process for existing CUSOs. One commenter suggested that there should also be a 12 month period for a corporate to divest from impermissible CUSOs.

The Board is sympathetic to these concerns about the transition to the preapproval system. Accordingly, the requirement in the final rule that NCUA preapprove CUSO activities will not become effective until [INSERT DATE 180 AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], so as to provide time for application to NCUA and NCUA review. Further, the final rule will permit a corporate an additional 12 months to extricate itself from an impermissible CUSO, if the corporate can demonstrate that, on the date of publication of the final rule, 1) the CUSO was actively engaged in the activity, and 2) the activity met all the requirements of §704.11 as that rule existed prior to effective date of final rule.

A few commenters stated that, for state chartered corporates, the states should determine what CUSO activities were appropriate. One commenter stated that NCUA should retain only the authority to “restrict an activity that is determined to present an undue material risk to the insurance fund.”

It is the intent of the Board that NCUA will review corporate CUSO activities for their potential impact on the insurance fund. Unfortunately, the Board cannot know in advance every sort of activity that a CUSO might wish to engage in that might have a negative impact on the NCUSIF. Accordingly, the proposed preapproval process is necessary. This is particularly true given that corporate CUSO activities present greater systemic risk to the credit union system, and the NCUSIF, than natural person credit union CUSO activities.

Many commenters wanted to know if existing CUSOs, and existing activities, would be exempt from the approval process (i.e., grandfathered). Several

commenters stated that previously approved corporate CUSOs and CUSO activities should be added to NCUA's approved list of CUSO activities in the proposed rule text; two commenters stated that NCUA is "aware" of current CUSO activities, and so should preapprove those current CUSO activities in the regulation. Another NPCU stated that a corporate should simply notify NCUA of what CUSOs it had and what they were doing and should not have to seek any NCUA approval, and that NCUA could obtain all the information it needs about the CUSO from "public" sources.

The Board will not be grandfathering preexisting CUSO activities. NCUA has not previously approved any existing CUSO activities, and is not necessarily fully aware of all activities that corporate CUSOS currently undertake or intend to undertake. Many CUSOs are privately held, and public sources provide insufficient information about what these CUSOs are doing.

704.11(g) Written agreement with CUSO.

704.11(g) (5). Agreement to provide NCUA expanded access.

The proposal also amends NCUA's CUSO access authority, currently limited to the CUSO's "books, records, and any other pertinent documentation," to include access as well to a CUSO's "personnel, facilities, and equipment."

Several commenters objected to the proposed expansion of NCUA access to a corporate CUSO, most believing it was overly intrusive and disruptive. Some of these commenters who disliked the proposed NCUA access did acknowledge that corporates might shunt nonperforming assets or problematic activities off to CUSOs, or that some particular corporate CUSO activities might pose particular risk to corporates or NPCUs, and these commenters generally thought that perhaps NCUA should be able to obtain access to corporate CUSOs, but only for "material" risks. One of these commenters stated that "for example, CMBS and SimpliCD may pose the threat of material losses in contrast to a corporate's minority interest in MDC or CUDL." None of these commenters, however, specified how, or by whom, such materiality would be determined.

As these commenters acknowledge, the NCUA is concerned about the potential migration of activities and risk from the corporates to their CUSOs. If the NCUA

believes it needs access to a particular CUSO, it cannot be placed in the position of arguing with the corporate, or the CUSO, about whether the perceived risk is “material.” Accordingly, the Board declines to adopt that standard for CUSO access.

Some commenters expressed concern that the expanded NCUA access envisioned for corporate CUSOs might cause third party service providers to decline credit union investment for fear of being categorized as a CUSO. In response, the Board notes that service providers cannot generally accept direct credit union investment without becoming CUSOs, but that the CUSOs of natural person federal credit unions are permitted to engage in the following activity:

*CUSO investments in non-CUSO service providers:* In connection with providing a permissible service, a CUSO may invest in a non-CUSO service provider. The amount of the CUSO’s investment is limited to the amount necessary to participate in the service provider, or a greater amount if necessary to receive a reduced price for goods or services.

12 CFR 712.5(r). If a corporate wants to invest a minimal amount in a third party service provider, but insulate the service provider from NCUA access and oversight, the corporate can request approval from NCUA to add such an investment activity above as an approved corporate CUSO activity. Before approving such a CUSO investment activity, however, the corporate or its CUSO would have to explain the arrangement, including the extent of the proposed investment by the CUSO in the service provider and why NCUA access to the particular service provider is not necessary to ensure protection of the NCUSIF.

Some commenters thought NCUA did not have the expertise to examine CUSO activities, or that regulation by state regulators, or that NCUA access to CUSOs through NPCU FCU owners, would be sufficient. In fact, NCUA doubts that it would ever become the primary regulator of a CUSO, or would conduct routine exams of any particular CUSO. The intent of the provision is to ensure that NCUA can get quick and complete access to a CUSO should the need arise.

Some commenters believe that access by NCUA would only be appropriate where the corporate has a “controlling interest,” as opposed to a minority interest. The Board disagrees. Three or four corporates, or corporates and other credit unions, could form a CUSO where no one credit union had a controlling interest,

and this CUSO could present the same risk to the credit union system as a CUSO that is controlled by one corporate.

One corporate commenter stated that the proposal “appears to give the NCUA expanded authority over a CUSO simply by virtue of a corporate credit union holding stock in a CUSO.” This commenter did not see why a corporate CUSO should receive different NCUA supervision than a natural person credit union CUSO. This commenter does not understand that NCUA has long required, for both natural person FCU CUSOs and corporate CUSOs, that the CUSOs permit NCUA access to their books, records, and documentation. *See, e.g.*, 12 CFR 712.3(a)(3). Given the expanded rule that corporate CUSOs are likely to play in the future of the credit union system, the proposal ensures that NCUA has access commensurate with the systemic risk that corporate CUSOs may present.

Accordingly, and except as described above, the Board adopts the final §704.11 as proposed.

#### **§ 704.14. Representation**

##### *Proposed revisions.*

The proposal required that all corporate board members hold either a CEO, CFO, or COO position at their member credit union or other member entity. The proposal also required that a majority of a corporate’s board members be representatives of natural person credit union members and that individual board members, and the organizations they represent, be limited to no more than six consecutive years of board service. In addition, the proposal prohibited any person from sitting on the boards of two or more corporates at the same time, and would preclude a single organizational member from having more than one individual representative on the board of any given corporate. Some aspects of the proposal, such as the requirement that a majority of the corporate board be representatives of natural person credit unions, would be phased in over time. The provisions governing term limits would have taken effect at the time of the next election to the board, so that no currently sitting director would have to resign before his current term expired, regardless of the length of time he had been on the board.

##### *General comments on the proposal.*

Some commenters asserted that NCUA's efforts to impose limits or standards in the area of board membership were excessive and beyond the scope of what was appropriate for the regulator. Many stated that attempts to regulate in this area usurped the rights of the membership to make their own decisions concerning their representatives and were inconsistent with the democratic principles that are fundamental to credit unions.

The NCUA has long been in the business of setting standards for credit union governance. The Federal Credit Union Act, for example, provides the Board with specific authority to promulgate standard FCU bylaws, as well as general authority to regulate both federal credit unions and federally insured credit unions, and to protect the NCUSIF. See, e.g., 12 U.S.C. 1758. Corporate credit unions play a fundamental role in the credit union system, creating both significant systemic benefits and significant systemic risks, and the make-up of the board of directors has a significant impact on the risk to the NCUSIF. Accordingly, NCUA has, for many years, established governance parameters for corporates. While members retain the right to elect directors, for example, the NCUA has previously imposed governance requirements, such as standard federal corporate bylaws and rules pertaining to conflicts of interest and overlapping relationships between directors and trade associations that apply to all corporates. The proposed and final governance provisions are consistent, in form and content, with these principles.

Some commenters questioned whether the proposed limits and restrictions would have made any difference in avoiding the losses that corporates sustained during the recent market dislocation. Whether or not these new provisions might have affected the size or scope of the losses is not determinable. Still, the Board reiterates its belief that improving and strengthening corporate governance will help corporate credit unions to survive whatever market conditions they must face in the years ahead.

Another commenter, representing the views of state regulators, asserted that issues such as director qualifications and term limits for state chartered entities rightfully come under the province of state law, as administered by state regulators, and that NCUA has no business regulating for all corporates in these areas. In response, the Board reiterates that part 704 has historically been applicable to all corporates, including state chartered corporates, because of their systemic risk to the credit union system and the NCUSIF. The final rule contains several requirements and references to collaboration between NCUA

and the relevant state regulator when working with state chartered corporates, and the Board intends the tradition of collaboration will continue.

Some commenters expressed concern that NCUA may elect to impose some or all of the proposed governance requirements on directors of natural person credit unions. The Board did issue a proposed rule in July, 2010, that would extend the golden parachute and indemnification provisions originally proposed for corporates to all insured credit unions. 75 FR 47236 (Aug. 5, 2010). The Board does not, however, presently anticipate that any of the other governance provisions in this rule, as proposed or finalized, will also be extended to natural person credit unions.

A discussion of the specific governance revisions adopted in the final rule follows.

704.14(a) Board representation.

704.14(a)(2). Boards limited to CEOs, CFOs, or COOs.

The proposed 704.14(a)(2) prospectively limited those who could seek reelection to sitting CEOs, CFOs, or COOs.

A large number of commenters opposed the requirement that service on the board of a corporate be limited to individuals currently holding the position of CEO, CFO, or COO of a member institution. Several commenters noted that many credit unions are run by individuals holding the title of manager or treasurer, and that the rule should be changed to accommodate such circumstances. Many commenters criticized this provision as being, simultaneously, overly restrictive and ineffective. These commenters stated that there may be many individuals with the willingness, capacity, and expertise sufficient to enable them to be very effective members of the board, but who may not hold one of these three titles. These commenters believe that accountants, attorneys, and capital market specialists, for example, may all have the type of background that could be of value to a corporate credit union. Some commenters also supported extending the qualifications to retirees. Commenters also noted that just having one of the three enumerated titles is no assurance that an individual will exhibit the requisite competence or commitment required to be a successful member of the board. Many commenters questioned whether any evidence exists to support the view that any of the problems currently

afflicting the corporate sector can be attributed to boards being comprised of individuals lacking these titles; many also suggested that the imposition of this requirement would have done nothing to avert the problems that were encountered. Several noted, for example, that there was no shortage of persons holding these titles on the boards of the two corporates currently in the conservatorship of the NCUA.

Many commenters complained that, by imposing this restriction, the agency would be overstepping the boundary of appropriate regulatory oversight and treading on territory that is more properly left to the membership. These commenters believe that the democratic principles that have always characterized the member-owned, member-controlled credit union movement require that members be allowed to make their own decisions about whom to elect to the board. Many of these commenters suggested that a more appropriate approach for NCUA to take in this respect would be to impose a requirement that nominating committees establish guidelines concerning education and experience criteria that must be met by candidates for board positions. Alternatively, many commenters proposed that NCUA approach this issue by requiring corporates to implement mandatory training and continuing education programs for all directors, possibly through a new bylaw provision establishing such a requirement. Some suggested that NCUA simply impose an experience requirement, such as five years working in the credit union sector, as a prerequisite to eligibility to serve on a corporate board; one suggested imposing a minimum age for service on the board. Another commenter suggested imposing a requirement that directors may only come from member credit unions with a specified minimum level of investment in the corporate. Several commenters also urged NCUA to require corporates to adopt best practices for boards to follow in this context, including provisions dealing with attendance, training, self assessment and review.

A few commenters, typically representing smaller credit unions, believed that one probable outcome of this rule would be that smaller credit unions, which typically have relatively few employees, could be effectively excluded from representation on boards. In some cases, for example, the CEO (or Treasurer/Manager) may be one of only two or three full time employees. The credit union may be unable to spare the individual or allow him or her to devote the type of time commitments required of board membership. Consequently, according to these commenters, many such credit unions may go without representation at their corporate.

Other comments on director qualifications included the suggestion that NCUA allow directors of corporates to be paid for their service on the board. Several commenters also suggested that NCUA should allow up to 20 percent of the board to consist of outside directors, specifically to include individuals with capital market knowledge and experience, provided that NCUA also establish and impose appropriate safeguards to protect against conflicts of interest involving such individuals. One commenter suggested extending the qualification concept to include executive officers, by imposing a knowledge or experience requirement before individuals may take a position with responsibility for finance, investment, credit risk and enterprise risk areas of the corporate's business.

The Board acknowledges that, in the case of some natural person credit unions, the person fulfilling the role of chief executive actually holds the title of Treasurer/Manager. This title, which is perhaps more common among smaller credit unions, has traditionally been used as a more descriptive term for what the chief executive actually does on a day to day basis. In any event, the Board recognizes that the same rationale that deems a CEO as qualified to serve on the board of a corporate should apply equally to the case of persons holding the Treasurer/Manager title. Accordingly, the final rule has been expanded to include this position in the category of persons qualified to fulfill the role of corporate credit union director.

The Board has elected not to make additional changes to the proposed rule. Although the Board recognizes that some individuals who are not employed in one of the identified, qualifying positions may actually have the ability to serve on a corporate board, the Board nevertheless believes the listed positions (as noted above, expanded to include Treasurer/Managers) provide a good proxy for the most qualified, experienced and capable individuals in the credit union industry. These are, in other words, the very persons whose knowledge, skills and abilities are necessary to guide and direct corporates through to the next stage of their business.

The Board notes, in this respect, that corporate boards are free to retain the services of subject matter experts as consultants or advisors to the board, to the extent that such expertise in a particular field, such as capital markets or real estate, should be viewed as necessary. Corporates are also free to propose non-standard bylaw provisions that would require, for example, that incumbent directors must receive periodic training from qualified sources on issues of

importance to the corporate's operations and business model, including such aspects as capital markets and investments, asset-liability management, accounting and regulatory compliance. As the Board noted in the preamble to the proposed rule, citing Corporate Credit Union Guidance Letter 2005-02, directors must have considerable knowledge and devote sufficient time to have an adequate understanding of a corporate's operations. If anything, these principles have greater urgency in 2010 than they had in 2005 when that Guidance Letter was first issued. The Board also rejects the notion of allocating some portion of director slots to outside directors, as this would be inconsistent with the democratic principles that have always been fundamental to the credit union industry.

704.14(a)(3). Term limits.

The proposed paragraph 704.14(a)(3) provided generally that no corporate board members could seek election if, at the end of the term to which elected that board member would have served more than six consecutive years.

The issue of a mandatory 6-year term limit for board members attracted, by far, the most comment within the sphere of comments directed toward the governance aspects of the proposal, with hundreds of commenters opposed to the proposed term limit. Many commenters opposed the notion of term limits altogether, arguing that members should not be constrained in their ability to select individuals of their own choosing to serve on the board. These commenters argued that NCUA would be exceeding its proper role by establishing an arbitrary barrier that would undermine freedom of choice of the membership. Virtually all of the persons who commented on the term limit proposal asserted that a 6-year period is too short. These commenters argued that a 6-year period would create significant disruption in the management and operation of corporates, at a time when significant challenges to their survival are foreseeable and when the full attention and concentration of the board will most be required. Many commenters expressed concern that the effect of the term limit provisions would be to severely disrupt the institutional knowledge available to the board. Several pointed out that six years is less than the duration of the typical business cycle. One commenter predicted that the turnover caused by the proposed term limit would create "havoc;" and many others cautioned against the likelihood of unintended consequences should the provision become final.

Some of these commenters may have misread the proposal, as it would not require any currently sitting director to resign his or her seat. Instead, it would apply to those seeking re-election. Most corporate boards should have staggered terms, such that only a percentage of the entire board is up for re-election each year. Nevertheless, the Board acknowledges the concern identified by some commenters who indicated that, at least initially, the average remaining tenure for current board members would probably be about three years under the proposal.

Some commenters argued that corporate boards are substantially different from NPCU boards and that a dramatically greater learning curve exists before a director can typically acquire the level of knowledge and expertise he or she needs to make a meaningful contribution to the work of the board. These commenters believe that a 6-year term limit would require experienced directors to exit the board just at the time they had become productive, leaving the corporate dangerously exposed to the oversight and management of an inexperienced board.

Other points argued by commenters in opposition to the 6-year term limit included that management officials of the corporate would become more vulnerable to pressure to implement short-sighted policies or programs to meet the direction of board members who will not be with the corporate long-term. Another point raised by several commenters representing or served by corporates in small or rural states is that the universe of candidates available for service on the board is relatively small, and that the turnover required by a 6-year term limit would create a hardship for those corporates to recruit and retain capable directors. Some commenters called for the grandfathering of service by existing board members completed before the final effective date of the rule; a few asserted that the rule should not be applied to cover the term of service of an individual appointed to fill an unexpired term, lest such individual be precluded from seeking two elected terms, which the rule would ostensibly permit.

Commenters opposed to the 6-year limit suggested a wide range of alternatives. Most commenters suggested that, if required at all, the term limit should be extended to 9 or 12 years, to allow for the development of appropriate experience on the board and to dampen the impact of sudden, massive turnover; some commenters proposed a 10 year or 15 year term limit, and one even advocated for 20 years. Another suggested allowing the lesser of four

consecutive terms or nine years, while another suggested abandonment of term limits for directors but imposing a specific limit on the time a board member may hold a particular board office, such as chairman, etc.

The Board is persuaded by the arguments made by commenters to the effect that the imposition by rule of mandatory term limits for directors is inconsistent with the democratic principles on which credit unions are founded. Accordingly, the final rule deletes the proposed paragraph 704.14(a), with its associated mandatory term limit, and renumbers the remaining subparagraphs of 704.14(a). The Board notes that individual corporates may as a matter of policy determine that some sort of limitation on consecutive service by directors is appropriate. In such cases, the corporate is free to propose a non-standard bylaw imposing reasonable term limits. The corporate could also, for example, impose an internal requirement that board offices, such as board chairman, be rotated among directors in accordance with a prescribed schedule.

704.14(a)(4). Individual service on more than one corporate board.

The proposed paragraph 704.14(a)(4) prohibited any individual from being elected or appointed to serve on the board if, after such election or appointment, the individual would be a director at more than one corporate credit union. The NCUA did not receive any significant comment on this proposal, and there is no change to it in the final (other than renumbering to (a)(3)).

704.14(a)(5). Multiple member representatives on corporate board.

The proposed paragraph 704.14(a)(5) prohibited any individual from being elected or appointed to serve on a corporate board if, after such election or appointment, any member of the corporate credit union would have more than one representative on the board of the corporate. The NCUA did not receive any significant comment on this proposal, and there is no change to it in the final rule (other than renumbering to (a)(4)).

704.14(a)(10). Majority of directors must be NPCU representatives.

The proposed paragraph 704.14(a)(10) required that at least a majority of directors of every corporate credit union, including the chair of the board, must serve on the board as representatives of natural person credit union members. This requirement would be effective 36 months after publication of the final rule in the Federal Register. The commenters addressing this proposal were generally

supportive, and there is no change to it in the final (other than renumbering to (a)(9)).

Accordingly, and except as discussed above, the Board adopts the final §704.14 as proposed.

**(Current) § 704.19 Wholesale corporate credit unions.**

The proposal would eliminate the current §704.19, which grants wholesale corporate credit unions a lesser RE reserve requirement than the requirement generally applicable to retail corporates.

No commenters objected to the elimination of this provision, and the final rule eliminates it.

**(Proposed and Final) § 704.19 Disclosure of executive and director compensation.**

The proposal would have required that each corporate prepare, on an annual basis, a document that discloses the compensation, in dollars, of each senior executive officer and director. Compensation is broadly defined, and includes benefits, deferred payments, informal arrangements, and payments made to acquaintances and relatives. Any member of the corporate could obtain a copy of the disclosure upon request, and the corporate would also be required to distribute the information to its members at least once a year, in the annual report or by some other means of its choosing. The proposal would have permitted the corporate to include with the disclosure additional information if necessary to put the disclosure in context. With respect to any corporate merger, a merging federally-chartered corporate would be required to affirmatively disclose to both NCUA and its members any material, merger-related increase in compensation (i.e., an increase of more than 15 percent of annualized compensation or \$10,000, whichever is greater) for any senior executive or director. The proposal would have also required a state-chartered corporate to make the merger-related disclosure, but only to NCUA unless state law requires otherwise.

*General comments.*

Many commenters expressed concern with this aspect of the proposal.

Several expressed opposition based on privacy, arguing that an executive's compensation is no one's business except his or her own. Others took the view that the proposed disclosure requirements were punitive in nature and would not, had they been in place, have had any significant impact on helping corporates weather the recent market dislocation and economic crisis.

The Board disagrees that the disclosure requirements are in any way punitive or violative of legitimate privacy expectations. The rule is designed to assure that corporate credit union members are aware of the level of compensation paid to senior management officials. As the Board noted in the preamble to the proposed rule:

The member-owners of a corporate credit union have a strong financial interest in the corporate. The typical corporate member has large investments in the corporate and much of this investment is at risk, either in the form of paid-in capital, membership capital, or uninsured shares. The corporate member has a powerful interest in ensuring this at-risk investment is properly managed and protected. That interest extends both to ensuring the corporate provides proper financial incentives to its managers to do a good job and also that the corporate is properly expending its funds – information categories that both include senior management compensation.

74 FR 65210, 65252 (December 9, 2009). The Board believes the members' interest in this information outweighs any privacy interests the senior managers may have in the information. The Board also believes these interests exist whether or not such information would have mitigated the corporate losses sustained during the last two years.

Many commenters predict that the disclosures will make recruitment and retention of qualified senior executives much more difficult, as potential candidates will opt for other positions not subject to potential disclosure. The Board disagrees, as discussed further below. Other commenters argued that adequate methods currently exist for members to gain access to compensation information, while several asserted that compensation information should only be accessible to the NCUA, which ought to use its own regulatory powers and oversight to assure that arrangements are not unreasonable. Some commenters asserted that information should be made available only on an aggregate basis,

or should only be made available to members on request, rather than disseminated.

The Board is of the view that disclosure on an aggregate basis would not provide the level of warranted transparency. Further, the Board does not believe NCUA's role should be the arbiter of appropriate compensation in lieu of the members.

A few commenters evidently misread the disclosure requirement and complained that the disclosure should not be made to members of the public or to the media, which in fact the proposal does not require. Other commenters called for the rule to allow corporates to present the compensation information in their own preferred format, with contextual information, which is also permissible under the current proposal. One commenter asked for a definition of the term "compensation" for purposes of the required disclosure. The proposed rule, however, does contain a detailed definition of "compensation" in §704.2.

704.19(a) Annual disclosure.

The proposal required that corporates must annually prepare and maintain a disclosure of the compensation, in dollar terms, of each senior executive officer and director.

Several commenters made the point that, as currently defined, the term "senior executive officer" would extend to individuals who may hold a title, such as vice president, but who are not truly senior level executives with program level or operational authority or responsibility. Commenters suggested that these are not the types of employees who ought to be subject to the disclosure requirements. Many commenters suggested that NCUA adjust the rule to limit it to the truly senior level executives, for example by limiting the disclosure obligation to the CEO and the executives who report directly to the CEO, or by limiting the disclosure to include only the top five officials in terms of compensation. Another suggestion was to simply establish a compensation threshold and extend the disclosure obligation to all earners receiving income above the threshold. Several suggested that NCUA follow the SEC rules on identifying which are the truly senior level officials for purposes of this disclosure obligation. Others suggested that NCUA should simply adopt and follow the approach applicable to those state chartered corporates that must file the IRS Form 990 compensation disclosures.

The Board agrees that the proposal was very broad. In many corporates, individuals may hold the title of vice president but not necessarily have program level or operational authority. Mandatory disclosure of compensation paid to such individuals would extend the concept of transparency beyond what the Board considers to be a reasonable level. Accordingly, the Board has modified the final paragraph 704.19(a) so that disclosure is required only of compensation paid to approximately the top ten percent of employees with, generally, a minimum of three employees who must disclose and a maximum of five. Specifically:

- Final paragraph (a)(1) requires corporates with 41 or more employees must disclose compensation paid to the top 5 most highly paid individuals.
- Final paragraph (a)(2) requires corporates with between 30 and 41 full time employees must disclose the compensation paid to the 4 most highly compensated employees.
- Final paragraph (a)(3) requires corporates with 30 or fewer full time employees must disclose compensation paid to the 3 most highly paid individuals.

In addition, final paragraph (a)(4) requires that compensation paid to the corporate's chief executive officer must also be disclosed, if the chief executive officer is not already included among the most highly compensated employees described in subparagraphs (a)(1) through (a)(3).

The Board also determined to remove the reference to directors from paragraph 704.19(a), as it is highly unlikely that a director, in his or her capacity as director, would be among the most highly compensated individuals at the corporate.

The Board believes this revised compensation disclosure provision strikes a reasonable compromise between the right of the corporate's members to know the level of compensation paid to its senior staff and the expectation of privacy that mid and junior level executives have concerning their personal affairs. Also, as discussed in the preamble to the proposed rule, the Board has concluded that the disclosures in the IRS Form 990 are an insufficient substitute for those required in this final rule.

The Board did not receive any other significant comment on the proposed provisions of §704.19. Accordingly, and except as described above, the Board adopts the final §704.19 as proposed.

## **§ 704.20. Limitations on golden parachute and indemnification payments.**

The proposal would have prohibited golden parachutes, that is, payments made to an institution affiliated party (IAP) that are contingent on the termination of that person's employment and received when the corporate making the payment is either troubled, undercapitalized, or insolvent. The proposal would have also generally prohibited a corporate, regardless of its financial condition, from paying or reimbursing an IAP's legal and other professional expenses incurred in administrative or civil proceedings instituted by NCUA or a state regulatory authority where the IAP is ultimately found liable. For federal corporates, the proposed indemnification limits would be in addition to the requirements of §701.33.

### *General comments.*

Most commenters that expressed concern about the proposal believed it might inhibit the ability of a corporate to recruit and retain qualified individuals willing to serve as board directors. Several commenters stated that, unlike their counterparts in the banking sector, these individuals serve without pay, on a voluntary basis. Some commenters expressed concern that many such individuals will be unwilling to serve as board members if they believe their own personal net worth is at risk and their corporate is unable to offer them protection against potentially unlimited personal claims.

The Board does not agree with these commenters. First, although most individuals who serve on the boards of corporates are technically uncompensated volunteers, they are, in fact, for the most part employees of NPCU members who are tagged to serve at the corporate by their NPCU and who do so as part of their responsibilities to the NPCU. So if the NPCU asks them to serve, they will. Second, the indemnification limitations in the proposal apply only to administrative enforcement actions brought by the NCUA or another appropriate regulator. Such actions, which often take the form of either a removal action or an attempt to prohibit an individual from serving on behalf of an insured depository institution in the future, do not typically threaten the targeted individual with "unlimited" personal liability. In addition, the Board notes that paragraph 704.20(a)(9) does allow for the purchase of director and officer liability insurance to protect the director. Finally, paragraph 704.20(e) of the proposal permits a corporate, if it makes a good faith determination that the affected

director was acting in a manner he or she believed to be in the best interests of the institution, to make reasonable indemnification payments subject to the director's written agreement to reimburse the corporate should the director ultimately be found liable. As a technical clarification, the final rule replaces the word "institution" with the word "membership" in paragraph 704.20(e)(1)(i). See 75 FR 15574, 15575 (March 29, 2010) and 71 FR 77150, 77155 (Dec. 22, 2006). Accordingly, and except as described above, the Board adopts the final §704.20 as proposed.

**E. PART 709 – INVOLUNTARY LIQUIDATION OF FEDERAL CREDIT UNIONS AND ADJUDICATION OF CREDITOR CLAIMS INVOLVING FEDERALLY INSURED CREDIT UNIONS IN LIQUIDATION.**

The proposed contained the following amended language for paragraph 709.5(b)(7):

[i]n a case involving liquidation of a corporate credit union, holders of nonperpetual capital accounts or instruments, subject to the capital priority option described in Appendix A of Part 704 of this chapter . . . .

The final rule amends the proposed language to read as follows:

[i]n a case involving liquidation of a corporate credit union, holders of then-outstanding nonperpetual capital accounts or instruments to the extent not depleted in a calendar year prior to the date of liquidation and also subject to the capital priority option described in Appendix A of Part 704 of this chapter . . . .

This is consistent with the final amendments to Model Form A in Appendix A, which include disclosure language that depleted capital has no claim against the

liquidation estate for claims filed beyond the fiscal year of depletion. For clarity, and to reduce the potential ambiguity associated with "fiscal year," the final rule also substitutes "calendar year" for "fiscal year." The final rule contains a similar amendment to 709.5(b)(9).

**Part 747 -- Administrative Actions, Adjudicative Hearings, Rules of Practice and Procedure, and Investigations**

## **Subpart M -- Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action on Corporate Credit Unions**

The proposal would add a new subpart M to Part 747, setting forth the procedures and due process available in connection with the PCA provisions of proposed §704.4.

The Board received very little comment on proposed subpart M, and the final rule adopts subpart M as proposed.

### **IV. Analysis of the Final Investment, Credit Risk, and ALM Provisions.**

The final rule requires that corporates strive to achieve 100 BP of retained earnings (RE) in the first six years. Of course, some corporates already have some amount of RE, and so achieving this 100 BP after six years may not be a challenge for them. For those that currently have little or no RE, they must earn about 17 BP a year on average to meet the 6-year mark. This section illustrates how a corporate might structure its investment portfolio to satisfy the RE growth requirements while complying with the new investment, credit risk, and ALM provisions in the final rule.<sup>27</sup> The intent of this section is to demonstrate that there are multiple possible approaches to portfolio construction available to corporates under the rule. NCUA does not promulgate or endorse a preferred asset allocation or structure.

Several public commenters wrote about the ability of a corporate to achieve the necessary RE growth under the restrictions of the rule, and some of these commenters provided sample corporate investment portfolios. NCUA identified

---

<sup>27</sup> The final rule also requires a corporate get to 200 BP in 10 years. We expect that a corporate that can get to 100 BP in 6 years has a reasonable chance to get to 200 BP in 10, particularly since the RE itself will start generating earnings. Also, the following modeling assumes a clean sheet balance sheet, that is, that the corporate is able to sell those assets on its existing balance sheet that cause it to violate the final corporate rule or that carry the possibility of significant future credit losses. The Board realizes that some corporates may be unable to entirely clean their balance sheet of such legacy assets. As discussed above in the Legacy assets section, NCUA might grant these corporates waivers of some corporate rule requirements, including a waiver of the maximum allowable time to build the retained earnings required by this regulation. Any waiver involving the required retained earnings growth rate, however, will tied to the documented amount of losses flowing from legacy assets identified in an approved action plan. 12 CFR 704.1(b).

12 different public comment letters with “model” investment portfolios, that is, investment portfolios recommended by the commenters as appropriate for corporates going forward. Among these 12 comment letters there were 3 unique, model portfolios. One unique portfolio was submitted by Southwest Corporate FCU and another by Magnus Enterprises.<sup>28</sup> A third portfolio was submitted by 10 different commenters. This latter portfolio was originally provided to NCUA by the Association of Corporate Credit Unions (ACCU).<sup>29</sup>

To analyze the efficacy of this final rule, this section first constructs a hypothetical corporate balance sheet that satisfies the restrictions of the final rule, and then demonstrates that this portfolio generates the necessary 17 BP of earnings growth per year. This section then includes a second hypothetical balance sheet, with a different asset allocation, that also generates sufficient RE. The section then examines the complete model balance sheets submitted by Southwest FCU, Magnus, and the ACCU. Each of these balance sheets uses a different asset allocation from both the NCUA hypothetical balance sheets and the other two model balance sheets. The analysis shows that each of these three unique balance sheets either does -- or can easily be modified to -- comply with the requirements of the final rule, and that each of these portfolios can generate more than enough RE inside the given balance sheet to meet the 17 BP annual RE growth requirement.

#### **A. Hypothetical Balance Sheet #1**

NCUA constructed a balance sheet with the following asset allocation, liability allocation, WAL, capital, and spread characteristics:<sup>30</sup>

<b>Hypothetical Balance Sheet #1</b>
--------------------------------------

---

<sup>28</sup> Both the Southwest and Magnus comment letters were dated February 17, 2010. These public comment letters, as with all public comment letters on proposed NCUA regulations, are available on NCUA’s website at [www.ncua.gov](http://www.ncua.gov). Additionally, the Magnus comment letter first appeared on the blog [www.unrealizedlosses.blogspot.com](http://www.unrealizedlosses.blogspot.com) and was likely drafted by the author of that blog.

<sup>29</sup> The ACCU analysis was provided to NCUA in an email from then ACCU Executive Director Brad Miller to Director, OCCU, Scott Hunt, Subject: ACCU Part 704 Analysis, dated February 22, 2010. For an example of a public comment letter that employs this particular ACCU portfolio, see the public comment letter from the California and Nevada Credit Union Leagues, dated February 17, 2010.

<sup>30</sup> This balance sheet differs from the one described by NCUA in the proposed rule. Changes in the final rule, such as the prohibition on private label RMBS, would affect that earlier hypothetical balance sheet.

Assets				
Sector	Percent of Balance Sheet	Spread to LIBOR (basis points)	WAL (Years)	WAL in 50% Prepayment Slowdown (Years)
FFELP Student Loans	10%	33	3	3.8
ABS -- Autos	5%	15	2	2.5
ABS -- Credit Cards	10%	25	3	3
Bonds -- Corporate	20%	82	3.5	3.5
Agency RMBS	15%	45	4 <sup>31</sup>	7
Overnight Investments	40%	0	0	0
Total	100%	29.7	1.7	2.03
Equity and Liabilities				
Overnight Shares	36%	-10		
Term Certificates	60%	0		
Member Capital	4%	0		
Total	100%	-3.6		
Net Interest Income (basis points)		33.3		

Model balance sheet compliance with the final corporate rule.

NCUA constructed the asset allocation so that it would comply with the restrictions of the final rule. Specifically:

- All NRSRO ratings are AA or better.
- There are no private label RMBS.
- Sector limits are observed.

<sup>31</sup> The final rule permits the actual WAL of Treasuries, Agency RMBS, and Agency GSEs to be reduced by a factor of 0.5 for purposes of the two WAL calculations. Accordingly, this 4-year WAL will be reduced to 2.0 years, and on the extension test, the 7-year WAL will be reduced to 3.5 years.

- The structured securities are primarily floating rate, so the IRR NEV test of 704.8(d) is satisfied<sup>32</sup>.
- The portfolio has a WAL of 1.7 years, which is under the 2.0 year limit in 704.8(f). The final rule permits the actual WAL of Treasuries, Agency RMBS, and Agency GSEs to be reduced by a factor of 0.5 for purposes of the two WAL calculations. Accordingly, this agency RMBS WAL will be reduced to 2.0 years.
- Under the prepayment slowdown scenario, the WAL extends only to 2.03 years, well within the 2.25 year limit required by 704.8(g). Corporate bonds do not prepay, so the extension test does not affect them; and the agency RMBS WAL of 7.0 years will be reduced, when multiplied by the 0.5 factor, to 3.5 years.

More information about the assets, liabilities, and capital used in the balance sheet follows.

Assets used in the balance sheet.

NCUA has allocated investments across five distinct asset classes that are permissible corporate investments. For diversification purposes, no asset sector, other than overnight investments, exceeds 20 percent of the portfolio (although the final rule permits greater concentration in several of these sectors). NCUA determined that 40 percent of the current average corporate credit union portfolio has maturities of less than 180 days, and NCUA used this for the overnight allocation percentage. Forty percent is also the median percentage allocation in the public commenter models.

The model uses current spreads over LIBOR, determined as of early August, 2010, for each asset class. NCUA used two primary sources of data for its spread numbers. The first source was Bank of America/Merrill Lynch's, US Securitization Research, Securitization Weekly, dated August 6, 2010. The second source was Wells Fargo Securities' Libor/Swap spreads for July 30, 2010. These sources were supplemented with actual market observations for a number of agency RMBS.<sup>33</sup> NCUA believes that these spread numbers represent typical spreads, although NCUA did find some particular CUSIPs of the same asset type, credit quality, and WAL that had better spreads.<sup>34</sup>

---

<sup>32</sup> Given today's low rate environment, NEV volatility should not be significant even with the existence of interest rate caps.

<sup>33</sup> For example, a Fannie Mae sequential pay floating rate CMO, CUSIP 31398RV51, with a 6.5 percent cap.

<sup>34</sup> Examples of particular securities follow.

**ABS – Auto.**

Example 1. CUSIP 34529LAD6, Issuer Ford Credit Auto Owner Trust, WAL 2Yr, 1<sup>st</sup> Settle Date 4/28/10, Coupon 1.32%, Maturity 8/14/10. On its settlement date 4/28/10, the price was 99.50 and the yield 1.5720. LIBOR 1Yr 1.2% (estimated). Spread over LIBOR: 37 BP

The FFELP student loan ABS spread data assumes a generic AAA-rated bond with a 3-year WAL. The auto ABS spread data assumes a generic AAA-rated bond backed by prime automobile loans with a 2-year WAL. Auto ABS backed by subprime automobile loans are also available in the market at wider spreads but these were not included in the portfolio. The credit card ABS spread data is for a generic AAA-rated bond with a 3-year WAL. The corporate bond portion of the portfolio assumes an equal allocation of generic AA-rated 2-year bonds paying 67 BP over LIBOR and generic AA-rated 5-year bonds paying 97 BP over LIBOR.

The WAL and WAL extension calculations above reflect the 0.5 reduction factor for the agency RMBS. The WAL life of the portfolio without the application of this factor would be 1.95 years and the WAL assuming a 50 percent slowdown in prepayments would be 2.40. This illustrates the benefit to the corporates of permitting longer WALs for U.S. Government and Agency securities.

*Liabilities used in the balance sheet.*

The overnight share allocation of 36 percent is based on the lowest observed month-end level of corporate overnight shares during the past 10 years. The average percentage of overnight shares for the five years leading up to the implementation of the corporate share guarantee was higher, ranging from 42 to 49 percent. The 36 percent figure is also comparable to the median of 42.5 percent in the models submitted by commenters. Many corporate credit unions use the federal funds effective rate for setting dividend rates on their overnight accounts; and NCUA used this benchmark to set the overnight rate at LIBOR – 10.

---

Example 2. CUSIP 06052MAB1, Issuer Bank of America Auto Trust, WAL 1Yr, 1<sup>st</sup> Settle Date 6/24/10, Coupon 0.91%, Maturity 8/15/10. On its settlement date 6/24/10, the price was 98.50 and the yield was 2.4574, LIBOR 1Yr 1.2 (estimated). Spread over LIBOR: 125 BP

**ABS – Credit Card.**

Example 1. CUSIP 02582JFT2, Issuer American Express, WAL 2.9Yr, 1<sup>st</sup> Settle Date 6/9/09, Coupon 1.69094%, Maturity 5/15/14. On its settlement date 6/9/09, the price was 100 and the yield was 1.6415. USD SWAP 3Year 1.30 (estimated). Spread over LIBOR: 34 BP

Example 2. CUSIP 36159JCC3, Issuer GE Capital, WAL 3Yr, 1<sup>st</sup> Settle Date 6/24/10, Coupon 2.21%, Maturity 6/15/13. On its settlement date 6/24/10, price 99.22, yield 2.4950, USD SWAP 3Yr 1.30 (estimated). Spread Over LIBOR: 120 BP

**ABS – Student Loan**

Example 1. ISIN USU82908AA93, Issuer SLM Student Loan Trust, WAL 0.9yr, 1<sup>st</sup> Settle Date 7/22/10, Coupon 2.25%, Maturity 7/22/11. On its settlement date 7/22/10, price 100.10, yield 2.1540, LIBOR 1Y 1.20 (estimated). Spread over LIBOR: 95 BP

Example 2. CUSIP 78445MAA8, Issuer SLM Student Loan Trust, WAL 3.4Yr, 1<sup>st</sup> Settle Date 3/11/10, Coupon 3.2%, Maturity 3/11/2014. On its settlement date 3/11/10, price 99.85, yield 3.2692, USD SWAP 3Yr 1.30 (estimated). Spread over LIBOR: 196 BP.

All these securities are rated AA- or higher.

The certificate allocation of 60 percent constitutes the remaining liabilities after setting overnight shares at 36 percent and contributed capital at 4 percent. The hypothetical balance sheet assumes certificates pay LIBOR flat, which is a reasonable spread over agency securities with similar maturities and is consistent with the assumptions in the models submitted by Southwest and the ACCU.

Contributed capital used in the balance sheet.

The balance sheet model assumes contributed capital is priced at LIBOR flat. Some, but not all, commenter models priced contributed capital at spreads as high as 150 BP or 200 BP over LIBOR. Most capital instruments pay dividends based on the financial condition and performance of the underlying organization rather than a strict formula, and the same should be true for corporate credit unions. Accordingly, NCUA believes that members should accept a lower dividend payment on their PCC and NCAs until such time as their corporate is able to accumulate sufficient earnings to satisfy the RE requirements of the final rule.

There are various ways that a corporate could structure its PCC and NCA dividend provisions to facilitate a corporate's RE goals. One way would be for a corporate to offer capital instruments with a spread of 100 to 200 BP above LIBOR, but which also clearly notes that in any given year, should the corporate fall short of a particular earnings growth goal, the actual dividend paid may be reduced as low as zero (on a noncumulative basis) to make up for the earnings shortfall. To the extent that a member receives a reduced dividend in a given year, the member should consider this reduction as a form of fee for services received.

Model balance sheet's ability to generate earnings.

There are three major components to the determination of whether a corporate can generate earnings and the amount of such earnings. One component is net interest income (NII), which is generally calculated by taking the difference between the interest generated by the corporate's loans and investments and subtracting off the cost of the corporate's liabilities. The other two components are the total non-interest income (TNII)(which is primarily fee income) and the operating expenses (OE). A corporate's earnings, or net operating income, is then calculated using the following equation:

$$\text{Net Operating Income (Earnings)} = \text{NII} + \text{TNII} - \text{OE}$$

Although the income on a corporate's investment feeds into the NII and not into either the TNII or the OE, assumptions about the latter two terms are important in estimating the corporate's ultimate ability to generate earnings. Accordingly, before looking at a corporate's asset allocation and the NII it can produce, a discussion of TNII and OE is in order. For purposes of this document we define the difference between TNII and OE as net operating expenses (NOE), because it will generally be a negative number. Then:

$$\text{Earnings} = \text{NII} + \text{NOE}.$$

For the most recent 12 months ending in June, 2010, the average corporate TNII was 25 BP, and the average OE was 40 BP. NOE, then, was a negative 15 BP and, for the corporate to generate the necessary 17 BP in earnings, it must strive to generate 32 BP in NII.

NCUA believes that approximating NOE at negative 15 BP is a good starting point for any analysis. The expected earnings of this hypothetical balance sheet are demonstrated here:

<b>Hypothetical Balance Sheet #1</b>	(Basis Points)
Net Interest Income (NII) (from model)	33.3
TNII	25
OE	40
NOE	(15)
<b>Net Income From Operations (Earnings)</b>	<b>18.3</b>

Accordingly, the asset allocation in hypothetical balance sheet #1 should produce about 18.3 BP of earnings growth a year, more than the necessary 17 BP of annual earnings necessary to meet the 6-year RE target.

Methods to improve earnings.

The Board believes that there are ways that any corporate, including the model corporate earning 18.3 BP a year above, can improve its RE growth. For example:

- A corporate might improve its NII by improved share pricing. Corporates have some measure of control of their dividend pricing structure, and they

need to account for asset yields when making decisions on funding strategies.

- The current positively shaped yield curve should improve earnings as securities roll down the yield curve.
- After a corporate has built some retained earnings it can, if necessary, improve its RE ratio by shrinking its assets.

NCUA also believes that corporates have some pricing power over the fees they charge their members, and higher fees result in higher TNII. In addition, corporates can become more efficient, reducing their OE. Higher TNII and lower OE result in an improved NOE. Currently, the average corporate NOE is about negative 15 BP, but NCUA believes that well-run corporates can reduce this NOE number over time – making it easier to generate the necessary NII to support earnings growth at 17 BP annually.

Historical corporate trends indicate that corporate NOE is, in fact, declining:

	2005	2006	2007	2008	2009	2010*
TNII	0.26	0.25	0.21	0.22	0.26	0.24
OE	0.48	0.46	0.41	0.45	0.43	0.38
NOE	-0.22	-0.21	-0.19	-0.23	-0.17	-0.14

\*Annualized

As the above chart illustrates, corporates have seen continued improvement in NOE (from -0.22 to -0.14) over the past five years. The only exception to this trend was in 2008. In that year, the improvement in NOE reversed temporarily, most likely due to a one-time spike of 5 BP in employee compensation and benefits. Absent that one time expense, NOE would have been negative 18 BP, right in line with the historical trend.

NCUA recognizes that the TNII, OE, and NOE information quoted above is average information and not necessarily reflective of any particular corporate and its business model. The Board notes, for example, that for purposes of analyzing its forward-looking model portfolio, Southwest Corporate FCU used TNII of 37.3 BP and OE of 45.3 BP, both significantly higher than the current corporate averages.<sup>35</sup> Yet Southwest's NOE – the difference between its TNII and OE – was only negative 12 BP. This is right in line with the improving corporate trends demonstrated above.

<sup>35</sup> Southwest FCU comment letter, p. 24.

## B. Hypothetical Balance Sheet #2

There are other balance sheets that differ from Balance Sheet #1 that should generate sufficient earnings going forward. For example, by reducing the allocation to corporate bonds, and increasing the allocation to Agency RMBS and adding some commercial mortgage backed securities (CMBS), a corporate might hold a balance sheet like this:

<b>Hypothetical Balance Sheet #2</b>				
<b>Assets</b>				
Sector	Percent of Balance Sheet	Spread to LIBOR (basis points)	WAL (Years)	WAL in 50% Prepayment Slowdown (Years)
FFELP Student Loans	5%	33	3	3.8
ABS - Autos	7%	15	2	2.5
ABS - Credit Cards	8%	25	3	3
Bonds - Corporate	12%	82	3.5	3.5
Agency RMBS	18%	45	4	7
CMBS	10%	130	5	5
Overnight Invest.	40%	0	0	0
<b>Total</b>	<b>100%</b>	<b>35.64</b>	<b>1.81<sup>36</sup></b>	<b>2.155</b>
<b>Liabilities</b>				
Overnight Shares	36%	-10		
Term Certificates	60%	0		
Member Capital	4%	0		
<b>Total</b>	<b>100%</b>	<b>-3.6</b>		
Net Interest Income (NII)		39.24		
TNII		25		

<sup>36</sup> After applying the 0.5 reduction factor to the Agency RMBS permitted by paragraph 704.8(h). The factor is also applied to the prepayment slowdown WAL.

<b>Hypothetical Balance Sheet #2</b>			
OE	40		
NOE	(15)		
<b>Net Income From Operations (Earnings)</b>	<b>24.24</b>		

Again, NCUA constructed this portfolio to be in compliance with the final rule, including the rule's requirements for asset credit quality, sector limits, the 2-year asset WAL limit, and the 2.25-year asset extension limit. Again, the spread sources used include Bank of America/Merrill Lynch's, US Securitization Research, Securitization Weekly, dated August 6, 2010; and Wells Fargo Securities' Libor/Swap spreads for July 30, 2010.

The other general assumptions about assets, liabilities, cost of capital, and TNII, OE, and NOE are also the same as in hypothetical #1. Since this Balance Sheet #2 earns more than Balance Sheet #1, the corporate could possibly pay its capital contributors more on their contributed capital. In fact, the corporate could pay up to LIBOR +150 on its contributed capital and still generate more than 17 BP of earnings each year.

### **C. Hypothetical Balance Sheet #3 (Southwest Corporate Federal Credit Union)**

Southwest Corporate Federal Credit Union (Southwest) submitted the following model balance sheet as part of its comment letter:

<b>Hypothetical Balance Sheet #3 -- Southwest Model (from Annex C)</b>			
<b>(all data in this table supplied by Southwest)</b>			
<b>Investments</b>			
<b>Investments and Loans</b>	<b>Percent of Balance Sheet</b>	<b>Spread to LIBOR</b>	<b>Maturity<sup>37</sup> (Years)</b>
Loans	7%	40	2.0
ABS – Autos	20%	35	2.0
ABS – Credit Cards	20%	38	2.0
FFELP Student Loans	18%	32	2.0
Agency	10%	10	1.0
Overnight	25%	-12	0.0
<b>Total</b>	<b>100%</b>	<b>21.2</b>	<b>1.40</b>
<b>Liabilities</b>			
Overnight Shares	65%	-18	0
Certificates	31%	0	0.7
Member Capital	4%	150	0.0
RUDE	0%		0.0
<b>Total</b>	<b>100%</b>	<b>-5.7</b>	<b>0.22</b>
<b>Asset / Liability WAL mismatch (years)</b>			
		1.18	
<b>Net Interest Margin (bps)</b>			
		26.9	
<b>Net Fee Income (bps)</b>			
		37.3	
<b>Operating Expenses (bps)</b>			
		45.3	
<b>Net Income From Operations ( bps)</b>			
		18.9	

<sup>37</sup> NCUA believes that Southwest meant this to be WAL, not maturity. In any event, the WAL would be less than or equal to the maturity.

Southwest stated that its model balance sheet has about \$7 billion in assets and is based on Southwest's recommendations and current business model.

Model balance sheet compliance with the final corporate rule.

This model appears to comply with the investment, credit risk, and ALM provisions of the final rule.<sup>38</sup> Specifically:

- The asset allocation complies with the sector limits of 704.6(d).
- The WAL of the assets, at 1.40 years, is less than the 2.0 year limit in 704.8(f).<sup>39</sup>
- The portfolio contains no private-label RMBS, which are prohibited under the final rule 704.5(h).
- The portfolio complies with the new asset extension test, that is, the new 2.25 year limit in 704.8(g) on WAL of assets assuming a 50% prepayment slowdown. While Southwest did not discuss this new extension test -- because it was not in the proposed rule -- Southwest's balance sheet mix indicates the portfolio would meet this requirement. For example, the most likely securities to have any extension risk are those with student loans and mortgages. If upon prepayment slowdown the student loan ABS extends to 3 years (market indications are an extension to 2.6 years) and the agency securities (assuming agency MBS) extend to 4 years (a 1.5 year WAL security was observed to extend only to 2.7 years), the WAL of the portfolio is still only 1.96 years. Even then, the WAL for agency mortgages can be reduced by a factor of 0.5 under the final rule, 704.5(h). Applying the 0.5 factor to these securities, the WAL of the extended portfolio would drop to only 1.76 years, again well below the 2.25 year limit.

Model balance sheet's ability to generate earnings.

As recognized by Southwest in its comment letter, this balance sheet generates sufficient income to pass the retained earnings goals established by the new

---

<sup>38</sup> NCUA assumes that the commenter constructed this portfolio in compliance with the NRSRO limits (AA-) and IRR NEV limits. These limits exist in the current corporate rule, and the final rule does not change the existing base limits.

<sup>39</sup> Southwest was concerned about the proposed cash flow mismatch sensitivity tests in the proposed rule, and its mismatch of 1.18 years would have violated one of those tests -- but both of those tests have been removed from the final rule.

corporate regulation. Projected retained earnings are well above 17 BP a year. For example, after 3 years, Southwest projected the RE growth at 57 basis points, and after 6 years Southwest projected an RE of 113 basis points.

NCUA notes that this model generates sufficient earnings even when capital holders are paid at LIBOR +150. Earnings would be enhanced if the rate of return on capital was reduced, even temporarily.

*Effect of changes in the spreads over time.*

Southwest expressed some concern that spreads, as they existed when it wrote to NCUA in February 2010, might tighten over time, thus reducing a corporate's ability to generate earnings. In Annex D of its letter, Southwest analyzed its model balance sheet under "historic" spread levels and concluded that its model asset allocation would not produce sufficient earnings at those historic levels.

NCUA agrees that spreads going forward will have an impact on a corporate's ability to generate earnings. It is impossible, however, to predict the future – spreads could tighten, widen, or even stay the same for a protracted period. And even if spreads change, it is uncertain as to the speed of change. In fact, no one can say if spreads will ever return to "historical" levels, or even what exactly those historical levels are. For example, Southwest's letter indicates it based its Annex D analysis on the past 9 years of historical data, and concluded that the spread over LIBOR for an Agency MBS was only 6 BP during this time period. Using a longer historical view of the past 20 years, however, Bloomberg data suggests the average 1-year Agency MBS spreads were much higher than 6 BP, with an average Agency MBS spread over this 20-year period of about 22 BP and a median of about 16 BP.

Corporates will have to adapt to changing spreads, including variances within asset classes. As suggested by Southwest FCU, its model asset allocation would have worked in February 2010, and NCUA believes the asset allocations in hypotheticals #1 and #2 above will work given today's spreads. The Board believes that corporates can adapt to changes in spreads, and the WAL limits in the final rule will provide corporates additional flexibility to shift allocations.

**D. Hypothetical Balance Sheet #4 -- Magnus Enterprises Model**

Magnus proposed a different investment model that grows RE at a successful rate:

<b>Hypothetical Balance Sheet #4 – Magnus Model (all data in this table supplied by Magnus)</b>			
<b>Assets</b>			
<b>Investments and Loans</b>	<b>Portfolio Percentage</b>	<b>LIBOR/EDSF Spread</b>	<b>Total WAL (Years)</b>
Agency Mortgages	35%	60	4
ABS – Autos	10%	25	0.6
ABS – Credit Cards	10%	30	1
FFELP Student Loans	15%	25	0.5
Overnight Investments	30%	-5	0.003
<b>Total</b>	<b>100%</b>	<b>28.75</b>	<b>1.6359</b>
<b>Liabilities</b>			
Overnight Shares	30%	-5	0.003
Certificates	70%	-5	0.5
<b>Total</b>	<b>100%</b>	<b>-5</b>	<b>0.3509</b>
<b>Net Interest Income</b>		<b>33.75</b>	

Model balance sheet compliance with the final corporate rule.

Again, this Magnus Balance Sheet #4 appears to comply with the investment, credit risk, and ALM provisions of the final rule. The portfolio contains no private label RMBS and complies with the final sector limits. The WAL of the assets, at 1.63 years, is under the 2-year WAL limit. In fact, since the final rule permits agency securities to multiply their actual WAL by a factor of 0.5 before applying the 2-year WAL, the effective WAL of this portfolio is well under 1.63 years. The asset liability mismatch of 1.285 years is not relevant, as the proposed cash flow mismatch tests have been removed from the final rule. And NCUA also believes that these assets, if prepayments slowed by 50 percent, would not cause the portfolio WAL to exceed 2.25 years, thus satisfying the asset extension test of 704.8(g).

Model balance sheet's ability to generate earnings.

The Magnus balance sheet generates a net interest income of 33.75 BP.

Magnus' letter discusses corporate operating expenses. The author believes, as NCUA does, that corporates can and will become more efficient. He asserts an operating expense level of 30 BP is achievable after cost reductions and potential mergers in the coming years. For purposes of analyzing the Magnus

model, however, NCUA used the current average, annual ratio of corporate operating expenses to daily average net assets of 40 BP.

Magnus believes that corporates have control over their cost of capital. Specifically, he says that:

I am not troubled by the lack of cost of capital in [NCUA's proposed rule] margin analysis. Any new capital that comes into the corporates is going to come from NPCUs and they all understand that their capital investment isn't really a traditional investment that pays a high annual yield. Instead, it's an investment that may not pay dividends for 10 years or more . . . . Members who value the cooperative nature of their relationship with their corporate should be willing to forsake the dividend on PCC and NCA in the short run in order for the corporate to rebuild retained earnings.

Magnus letter, p. 4. NCUA agrees with this quoted language, particularly the last sentence. Accordingly, for purposes of analyzing the Magnus model, the analysis assumes that capital pays only LIBOR flat.

Magnus' model does not address net fee income. For purposes of analysis, NCUA made the same TNII assumptions (25 BP) as discussed previously. Accordingly, the Magnus investment portfolio, with its primary emphasis on Agency MBS, would produce an annual RE growth of about 19 BP, as follows:

<b>Analysis of Magnus Model</b>	<b>(Basis Points)</b>
Net Interest Income	33.75
TNII	25
OE	40
NOE	(15)
<b>Net Income From Operations ( Earnings)</b>	<b>18.75</b>

This earnings growth exceeds the necessary 17 BP a year. Again, as discussed in connection with NCUA's hypothetical #1 above, there are multiple potential ways to further improve this RE growth. For example, the corporate could become more efficient, moving toward the 30 BP expense level discussed by Magnus; or the corporate could use its pricing power to increase its fee income or reduce its dividends.

### E. Hypothetical Balance Sheet #5 -- ACCU Model

As mentioned above, a number of commenters adopted or referenced a model developed by the Association of Corporate Credit Unions (ACCU), given in the table below:

<b>Hypothetical Balance Sheet #5 – ACCU Model</b>		
<b>(all data in this table supplied by ACCU)</b>		
<b>Assets</b>	<b>Percent of Balance Sheet</b>	<b>Spread to LIBOR</b>
Loans	10%	50
ABS – Autos	20%	37
ABS – Credit Cards	15%	42
FFELP Student Loans	5%	45
Structured Agency	15%	34
Bank Floaters	5%	29
Other Short-term	8%	12
CMBS	7%	100
Overnight	15%	4
Total	100%	36
<b>Shares and Equity</b>		
Overnight Shares	50%	0
Certificates	46%	0
Member Capital	4%	200
Rude	0	0
Total	100%	8
Net Interest Margin (basis points)		28
Other Income		18
Operating Expenses		32
Net Income		14

The ACCU asset allocation varies from both the Southwest and Magnus allocations. For example, the ACCU model includes wider variation in investment classes and, as with hypothetical #2 above, introduces some CMBS.

Model balance sheet compliance with the final corporate rule.

Again, this balance sheet appears to comply with the investment, credit risk, and ALM provisions of the final rule. For example, the portfolio contains no private label RMBS, and it complies with the final sector limits.

ACCU did not provide direct information about the WAL of its assets. However, it did provide data from which the asset WAL can be reverse engineered. Specifically, ACCU also provided this chart:

NEV SHOCKS	MAXIMUM
Rates +300 bp	-14.0%
Credit +100 bp	-30.3%
+Paydowns -50%	-32.7%

If a credit shock of 100 BP produces an NEV decline of 30 percent from a starting NEV of 4 percent, that equates to a difference in the WALs of the assets and liabilities of about 1.2 years. Given that ACCU's liabilities are half overnight and half certificates, and the certificates likely have an aggregate WAL of a year or less (as do the certificates in both the Southwest and Magnus models), the aggregate liability WAL of the ACCU model is likely less than 0.8 years, which would make ACCU's asset WAL less than 2.0 years, satisfying the WAL restriction in the final rule.

As for the asset extension test, ACCU indicates that a 100 BP shock to its portfolio, assuming a 50 percent prepayment slowdown, produces an NEV decline of 32.7 percent. This equates to an asset extension of less than two months, and so the asset WAL, with the slowdown, would be less than 2.25 years. Accordingly, the ACCU model satisfies the extension test of 704.8(g).

Model balance sheet's ability to generate earnings.

ACCU's bottom line of 14 BP annually is 3 BP short of the annual RE growth needed under the final rule. Although the ACCU model assumes lower net fee income than the Southwest model, in the ACCU model this lower fee income is offset by a lower operating expense estimate.

There are multiple ways a corporate starting with the ACCU model can adjust its earnings capacity to achieve the 17 BP target. For example,

- The corporate can improve its efficiencies and product pricing, as discussed earlier.
- The corporate could change its sector weighting slightly. For example, if the corporate shifted 5 percent of its portfolio from Auto ABS to CMBS, the portfolio return would improve by over 3 BP annually using ACCU's spreads.
- ACCU assumed its cost of capital would be 200 BP over LIBOR. Again, NCUA believes that NPCUs that desire corporate services should be willing to provide capital at little or no cost, at least temporarily. If the cost of capital in ACCU's model was reduced to LIBOR flat, for example, that would increase its operating income by 8 BP annually and put the corporate well over its 17 BP annual earnings target.

### Conclusion.

There are multiple, different asset allocations available to corporates under the restrictions of the new rule that should provide corporates the necessary earnings flexibility to meet the new RE growth requirements.

## **V. Further Revisions to the Corporate Rule.**

As discussed above, NCUA issued its proposed revisions to the corporate rule back in November 2009, more than ten months ago. Since that time NCUA has received significant feedback. NCUA received formal feedback in the form of 815 public comment letters with over 2,600 pages of comments. NCUA also received much informal feedback, for example, from the credit union industry (through numerous town hall meetings and webinars), from other federal regulators, and from the Kamakura Corporation.

Much of that feedback has resulted in changes from the proposed rule to this final rule. Some of the feedback, though, went beyond the scope of the proposed rulemaking. Ideas – even very good ideas – that are beyond the scope of the proposed rule are not addressed in this final rulemaking. Instead, the NCUA has considered some of these ideas and plans in the near future to issue another proposal with further revisions to the corporate rule. The Board believes it important, though, as corporates and credit unions move now to adapt to this

final rule, that they also have some information about what these pending proposals are.

Specifically, the Board will be proposing that:

1. Corporates be subject to internal control reporting requirements similar to those required under Section 36 of the FDI Act (for banks and thrifts) and the Sarbanes-Oxley Act of 2002 (for public companies). *See* 12 U.S.C. 1831m; Pub. L. No. 107-204; and 12 CFR part 363, Annual Independent Audits and Reporting Requirements (FDIC rulemaking integrating FDI Act Section 36 and certain Sarbanes-Oxley requirements).
2. At any given time, an NPCU would be limited to membership in one corporate of the NPCU's choice. An NPCU could belong to two corporates for a short period of time, but only when transitioning between those corporates.
3. The board of directors of a corporate must establish a risk management committee. The committee will include at least one independent risk management expert with sufficient experience in identifying, assessing, and managing risk exposures.
4. When the TCCUSF makes an assessment on FICUs, NCUA would ask all corporate members that are not FICUs ("non-FICUs") to make a voluntary contribution to the TCCUSF. Corporates will hold a membership vote to determine whether any non-FICU that fails to make the requested contribution should be expelled from the corporate.
5. Each vote by a corporate's boards of directors must be recorded in the minutes so that the vote of each individual director is apparent from the minutes.
6. Corporates would be permitted to charge their members reasonable one-time or periodic membership fees. The fees must generally be proportional to the member's asset size, and a member must be given at least six months notice of any new fee, or any material change to an existing fee.

In a sense, this final rulemaking is the first step in the remolding of the corporate rule, and the six proposals above are the second step. As much as practicable, NCUA intends to mesh the effective dates of these two rulemakings. As discussed above, the effective date for most of this final rule is [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Accordingly, the Board plans to move this second-step rulemaking along by issuing these six proposals at either the October 2010 or November 2010 Board meeting for a 30-day public comment period.

Also, although not involving any additional rulemaking, the Board plans to:

1. Consult with other federal financial regulators to create a data tracking system to enhance NCUA's ability to systemically conduct trend analyses to identify recurrent or network-wide issues, and
2. Upgrade NCUA's current guidance on corporate mergers into a formal corporate credit union merger manual.

NCUA intends to implement the data tracking system within nine months and publish the merger manual within six months.

## **VI. Regulatory Procedures**

### **A. Regulatory Flexibility Act.**

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact a proposed rule may have on a substantial number of small credit unions (those under ten million dollars in assets). This final rule only applies to corporates, all but one of which has assets well in excess of \$10 million. Accordingly, the NCUA Board certifies that this final rule will not have a significant economic impact on a substantial number of small credit unions, and, therefore, a regulatory flexibility analysis is not required.

### **B. Paperwork Reduction Act.**

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or modifies an existing burden. 44 U.S.C. 3507(d). For purposes of the PRA, a paperwork burden may take the form of either a reporting or a recordkeeping requirement, both referred to as information collections. NCUA identified and described several information collection requirements in the proposed rule, including new requirements in the following broad areas: capital and PCA, investments, ALM, CUSO procedures, and corporate governance requirements. As required by the PRA, NCUA submitted a copy of the proposed regulation to the Office of Management and Budget (OMB) for its review and approval. Persons interested in submitting comments with respect to the information collection aspects of the proposed rule were invited to submit them to the OMB at the address noted in the preamble to the proposed rule.

While NCUA received a substantial number of comments on the proposed rule, commenters did not specifically address the agency's estimates of burden hours

or costs, which estimates were set out specifically in the preamble as required by PRA. However, as discussed more fully in the preamble to this final rule, the Board has determined to make several changes in the final rule, and some of those changes affect the burden estimates for some aspects of the collection requirements. These changes, all of which have the effect of reducing the estimated burden, are discussed below.

ALM requirements.

The Board has determined to eliminate entirely the two cash flow mismatch tests that had been proposed (§§704.6(e) and (f) in the proposed rule). The final rule will retain as proposed the two-year weighted average limit and will now require a new, additional test with a 2.25 year weighted average life limit that assumes a 50 percent slowdown in prepayment speeds to limit extension risk. The new test must be done quarterly and will be required of and affect all corporates. As with the original proposal, corporates will be required to calculate and record the effective and spread durations for individual assets and liabilities to support the test results.

From an information collection standpoint, NCUA estimates that the net impact of this change will be a reduction by approximately 50 percent in the estimated burden hours associated with ALM requirements. Accordingly, the revised burden estimate for compliance with this revised requirement would be as follows:

27 corporates x 84 hours per year = 2268 hours.

Corporate governance requirements.

The final rule changes the provisions relating to disclosure of compensation by reducing the number of senior executives whose compensation must be disclosed. Many commenters noted that the original proposal could have had the effect of requiring disclosure of compensation for many individuals, such as some persons holding the title of vice president, who are not, in fact, in positions with program or operational level responsibilities. The Board has changed the language from the proposal to now limit the total number of required executives subject to disclosure to the top ten percent of most highly paid individuals, to a maximum of five. For corporates with thirty or fewer employees, the top three highly paid executives must be disclosed. In all cases, the compensation paid to the CEO must be included in the disclosure if the CEO is not in the most highly

paid ten percent. While the initial estimate of the burden for complying with this aspect of the governance provisions was not substantial, the Board believes the change will reduce the final burden by approximately 50 percent.

Accordingly, the revised burden estimate for compliance with this revised requirement would be as follows:

27 corporates x 5 hours = 135 hours.

Summary of collection burden (Revised).

With the revisions described above, NCUA estimates the total information collection burden represented by the final rule, calculated on an annual basis, as follows:

Capital restoration plans: 20 corporates x 50 hours = 1000 hours.

Retained earnings accumulation

Plans: 3 corporates x 50 hours = 150 hours

Notice of intent to redeem contributed capital: 10 corporates x 1 hour = 10 hours.

Notice of PCA category change: 10 corporates x 1 hour = 10 hours.

Ratings procurement: 27 corporates x 2 hours = 54 hours.

Investment action plans: 10 corporates x 20 hours = 200 hours.

ALM testing: 27 corporates x 84 hours = 2268 hours.

CUSO approval requests: 12 corporates x 2 hours = 24 hours.

Compensation disclosures: 27 corporates x 5 hours = 135 hours.

Merger related disclosures: 4 corporates x 5 hours = 20 hours.

Requests to make golden parachute and severance payments: 4 corporates x 4 hours = 16 hours.

**Total Additional Burden Hours:**

**3,887 hours.**

NCUA does not anticipate that the revisions discussed above will have any significant impact on the cost estimates set out in the proposed rule.

NCUA has submitted these burden revisions to the OMB. NCUA expects that OMB will review and approve the revisions, and publish its approval, in the near future.

### **C. Executive Order 13132.**

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order.

This final rule applies to all federally-insured corporates, including state charters. Nonfederally insured corporates must also agree by contract, as a condition of receiving shares or deposits from federally-insured credit unions, to adhere to the requirements of this part and submit to NCUA examinations. The executive order states that: “National action limiting the policymaking discretion of the states shall be taken only where there is constitutional and statutory authority for the action and the national activity is appropriate in light of the presence of a problem of national significance.” NCUA has plenary statutory authority to regulate corporate credit unions and federally insured credit unions. *See* 12 U.S.C. 1766(a) and 12 U.S.C. 1781 *et. seq.* Further, the risk of loss to federally-insured credit unions and the NCUSIF due to corporate activities are concerns of national scope.

The final rule does not impose additional costs or burdens on the states or have a significant effect on the states’ ability to discharge traditional state government functions. NCUA has determined that the corporate rule as a whole, and this rulemaking, may have an occasional effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. However, the

potential risk to the NCUSIF and the entire credit union system that would result without extending the entire corporate rule, including the revisions in this rulemaking, to all corporates is more significant than any such effects.

Accordingly, NCUA believes that the protection of corporates, the NCUSIF, and the entire system of federally-insured credit unions requires application of this final rule to all such corporates, and that this application is consistent with Executive Order 13132.

#### **D. The Treasury and General Government Appropriations Act, 1999-- Assessment of Federal Regulations and Policies on Families.**

The NCUA has determined that this rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

#### **E. Small Business Regulatory Enforcement Fairness Act.**

The Small Business Regulatory Enforcement Act of 1996 (Pub. L. 104-121) provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by section 551 of the Administrative Procedure Act. 5 U.S.C. 551. The Office of Management and Budget has determined that this rule is not a major rule for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996.

#### **List of Subjects**

12 CFR part 702

Credit unions, Reporting and recordkeeping requirements.

12 CFR part 703.

Credit unions, Investments.

12 CFR part 704.

Credit unions, Corporate credit unions, Reporting and record keeping

requirements.

12 CFR part 709.

Credit unions, Liquidations.

12 CFR part 747.

Credit unions, Administrative practices and procedures.

By the National Credit Union Administration Board on September 24, 2010.

---

Mary F. Rupp  
Secretary of the Board

Accordingly, NCUA amends 12 CFR parts 702, 703, 704, 709, and 747 as follows:

## **PART 702 – PROMPT CORRECTIVE ACTION**

1. The authority citation for part 702 continues to read as follows:

Authority: 12 U.S.C. 1766(a), 1790d.

2. Effective [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], revise paragraph (d) of §702.105 to read as follows:

§702.105 Weighted – average life of investments.

\* \* \* \* \*

(d) Capital in mixed-ownership Government corporations and corporate credit unions. For capital stock in mixed-ownership Government corporations, as defined in 31 U.S.C. 9101(2), and perpetual and nonperpetual capital in

corporate credit unions, as defined in 12 CFR 704.2, the weighted-average life is defined as greater than one (1) year, but less than or equal to three years;

\* \* \* \* \*

**PART 703 – INVESTMENTS AND DEPOSIT ACTIVITIES**

3. The authority citation for part 703 continues to read as follows:

**Authority:** 12 U.S.C. 1757(7), 1757(8), 1757(15).

4. Effective [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], revise paragraph (b) of §703.14 to read as follows:

§703.14 Permissible investments.

\* \* \* \* \*

(b) Corporate credit union shares or deposits. A Federal credit union may purchase shares or deposits in a corporate credit union, except where the NCUA Board has notified it that the corporate credit union is not operating in compliance with part 704 of this chapter. A Federal credit union’s aggregate amount of perpetual and nonperpetual capital, as defined in part 704 of this chapter, in one corporate credit union is limited to two percent of the federal credit union’s assets measured at the time of investment or adjustment. A Federal credit union’s aggregate amount of contributed capital in all corporate credit unions is limited to four percent of assets measured at the time of investment or adjustment.

\* \* \* \* \*

**PART 704 – CORPORATE CREDIT UNIONS**

5. Revise the authority citation for part 704 to read as follows:

Authority: 12 U.S.C. 1762, 1766(a), 1772a, 1781, 1789, and 1795e.

6. Revise §704.2 to read as follows:

## § 704.2 Definitions.

Adjusted trading means any method or transaction whereby a corporate credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from the vendor another security at a price above its current market price.

Asset-backed security (ABS) means a security that is primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders. Mortgage-backed securities are a type of asset-backed security.

Available to cover losses that exceed retained earnings means that the funds are available to cover operating losses realized, in accordance with generally accepted accounting principles (GAAP), by the corporate credit union that exceed retained earnings net of equity acquired in a combination. Likewise, available to cover losses that exceed retained earnings and perpetual contributed capital (PCC) means that the funds are available to cover operating losses realized, in accordance with GAAP, by the corporate credit union that exceed retained earnings net of equity acquired in a combination and PCC. Any such losses must be distributed pro rata at the time the loss is realized first among the holders of paid-in capital (PIC), and when all PIC is exhausted, then pro rata among all MCAs, all subject to the optional prioritization described in Appendix A of this Part. To the extent that any contributed capital funds are used to cover losses, the corporate credit union must not restore or replenish the affected capital accounts under any circumstances. In addition, contributed capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

Capital means the sum of a corporate credit union's retained earnings, paid-in capital, and membership capital. For a corporate credit union that acquires another credit union in a mutual combination, capital includes the retained earnings of the acquired credit union, or of an integrated set of activities and assets, at the point of acquisition.

Capital ratio means the corporate credit union's capital divided by its moving daily average net assets.

Collateralized debt obligation (CDO) means a debt security collateralized by mortgage-backed securities, asset-backed securities, or corporate obligations in the form of loans or debt. Senior tranches of Re-REMIC's consisting of senior mortgage- and asset-backed securities are excluded from this definition.

Collateralized mortgage obligation (CMO) means a multi-class mortgage-backed security.

Commercial mortgage-backed security (CMBS) means a mortgage-backed security collateralized primarily by multi-family and commercial property loans.

Compensation means all salaries, fees, wages, bonuses, severance payments, current year contributions to employee benefit plans (for example, medical, dental, life insurance, and disability), current year contributions to deferred compensation plans and future severance payments, including payments in connection with a merger or similar combination (whether or not funded; whether or not vested; and whether or not the deferred compensation plan is a qualified plan under Section 401(a) of the IRS Code). Compensation also includes expense accounts and other allowances (for example, the value of the personal use of housing, automobiles or other assets owned by the corporate credit union; expense allowances or reimbursements that recipients must report as income on their separate income tax return; payments made under indemnification arrangements; and payments made for the benefit of friends or relatives). In calculating required compensation disclosures, reasonable estimates may be used if precise cost figures are not readily available.

Contributed capital means either paid-in capital or membership capital accounts.

Core capital means the sum of:

- (1) Retained earnings;
- (2) Paid-in capital; and
- (3) The retained earnings of any acquired credit union, or of an integrated set of activities and assets, calculated at the point of acquisition, if the acquisition was a mutual combination.

Core capital ratio means the corporate credit union's core capital divided by its moving daily average net assets.

Corporate credit union means an organization that:

- (1) Is chartered under Federal or state law as a credit union;
- (2) Receives shares from and provides loan services to credit unions;
- (3) Is operated primarily for the purpose of serving other credit unions;
- (4) Is designated by NCUA as a corporate credit union;
- (5) Limits natural person members to the minimum required by state or federal law to charter and operate the credit union; and

(6) Does not condition the eligibility of any credit union to become a member on that credit union's membership in any other organization.

Daily average net assets means the average of net assets calculated for each day during the period.

Derivatives means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivative contracts, and any other instrument that poses similar counterparty credit risks.

Dollar roll means the purchase or sale of a mortgage-backed security to a counterparty with an agreement to resell or repurchase a substantially identical security at a future date and at a specified price.

Embedded option means a characteristic of certain assets and liabilities which gives the issuer of the instrument the ability to change the features such as final maturity, rate, principal amount and average life. Options include, but are not limited to, calls, caps, and prepayment options.

Equity investments means investments in real property, equity securities, and any other ownership interests, including, for example, investments in partnerships and limited liability companies.

Equity security means any security representing an ownership interest in an enterprise (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants and call options) or dispose of (for example, put options) an ownership interest in an enterprise at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor.

Exchangeable collateralized mortgage obligation means a class of a collateralized mortgage obligation (CMO) that, at the time of purchase, represents beneficial ownership interests in a combination of two or more underlying classes of the same CMO structure. The holder of an exchangeable CMO may pay a fee and take delivery of the underlying classes of the CMO.

Fair value means the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. If there is a principal market for the asset or liability, the fair value measurement is the price in that market (whether that price is directly observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date. In the absence of a principal market, the fair value measurement occurs in the most advantageous market for the asset or liability. The fair value of the

asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, the corporate need not identify specific market participants. Rather, the corporate should identify characteristics that distinguish market participants generally, considering factors specific to all of the following: a. The asset or liability; b. The principal (or most advantageous) market for the asset or liability; and c. Market participants with whom the corporate would transact in that market. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). Examples of valuation techniques include the present value of estimated future cash flows, option-pricing models, and option-adjusted spread models.

Federal funds transaction means a short-term or open-ended unsecured transfer of immediately available funds by one depository institution to another depository institution or entity.

Foreign bank means an institution which is organized under the laws of a country other than the United States, is engaged in the business of banking, and is recognized as a bank by the banking supervisory authority of the country in which it is organized.

Immediate family member means a spouse or other family member living in the same household.

Limited liquidity investment means a private placement or funding agreement.

Member reverse repurchase transaction means an integrated transaction in which a corporate credit union purchases a security from one of its member credit unions under agreement by that member credit union to repurchase the same security at a specified time in the future. The corporate credit union then sells that same security, on the same day, to a third party, under agreement to repurchase it on the same date on which the corporate credit union is obligated to return the security to its member credit union.

Membership capital means funds contributed by members that: are adjustable balance with a minimum withdrawal notice of 3 years or are term certificates with a minimum term of 3 years; are available to cover losses that exceed retained earnings and paid-in capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

Mortgage-backed security (MBS) means a security backed by first or second mortgages secured by real estate upon which is located a dwelling,

mixed residential and commercial structure, residential manufactured home, or commercial structure.

Moving daily average net assets means the average of daily average net assets for the month being measured and the previous eleven (11) months.

Mutual combination means a transaction or event in which a corporate credit union acquires another credit union, or acquires an integrated set of activities and assets that is capable of being conducted and managed as a credit union.

Nationally Recognized Statistical Rating Organization (NRSRO) means any entity that has applied for, and been granted permission to be considered an NRSRO by the United States Securities and Exchange Commission.

NCUA means NCUA Board (Board), unless the particular action has been delegated by the Board.

Net assets means total assets less loans guaranteed by the NCUSIF and member reverse repurchase transactions. For its own account, a corporate credit union's payables under reverse repurchase agreements and receivables under repurchase agreements may be netted out if the GAAP conditions for offsetting are met.

Net economic value (NEV) means the fair value of assets minus the fair value of liabilities. All fair value calculations must include the value of forward settlements and embedded options. Paid-in capital, and the unamortized portion of membership capital, that is, the portion that qualifies as capital for purposes of any of the total capital ratio, is excluded from liabilities for purposes of this calculation. The NEV ratio is calculated by dividing NEV by the fair value of assets.

Net interest margin security means a security collateralized by residual interests in collateralized mortgage obligations, residual interests in real estate mortgage investment conduits, or residual interests in other asset-backed securities.

Obligor means the primary party obligated to repay an investment, e.g., e.g., the issuer of a security, such as a Qualified Special Purpose Entity (QSPE) trust; the taker of a deposit; or the borrower of funds in a federal funds transaction. Obligor does not include an originator of receivables underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment.

Official means any director or committee member.

Paid-in capital means accounts or other interests of a corporate credit union that: are perpetual, non-cumulative dividend accounts; are available to

cover losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

Pair-off transaction means a security purchase transaction that is closed out or sold at, or prior to, the settlement or expiration date.

Private label security means a security that is not issued or guaranteed by the U.S. government, its agencies, or its government-sponsored enterprises (GSEs).

Quoted market price means a recent sales price or a price based on current bid and asked quotations.

Repurchase transaction means a transaction in which a corporate credit union agrees to purchase a security from a counterparty and to resell the same or any identical security to that counterparty at a specified future date and at a specified price.

Residential properties means houses, condominiums, cooperative units, and manufactured homes. This definition does not include boats or motor homes, even if used as a primary residence, or timeshare properties.

Residential mortgage-backed security (RMBS) means a mortgage-backed security collateralized primarily by mortgage loans on residential properties.

Residual interest means the ownership interest in remainder cash flows from a CMO or ABS transaction after payments due bondholders and trust administrative expenses have been satisfied.

Retained earnings means retained earnings as defined under Generally Accepted Accounting Principles (GAAP).

Retained earnings ratio means the corporate credit union's retained earnings divided by its moving daily average net assets. For a corporate credit union that acquires another credit union in a mutual combination, the numerator of the retained earnings ratio also includes the retained earnings of the acquired credit union, or of an integrated set of activities and assets, at the point of acquisition.

Section 107(8) institution means an institution described in Section 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(8)).

Securities lending means lending a security to a counterparty, either directly or through an agent, and accepting collateral in return.

Senior executive officer mean a chief executive officer, any assistant chief executive officer (e.g., any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller). This

term also includes employees of any entity hired to perform the functions described above.

Settlement date means the date originally agreed to by a corporate credit union and a counterparty for settlement of the purchase or sale of a security.

Short sale means the sale of a security not owned by the seller.

Small business related security means a security that is rated in 1 of the 4 highest rating categories by at least one Nationally Recognized Statistical Rating Organization (NRSRO), and represents an interest in one or more promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution, insured credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or a finance company or leasing company. This definition does not include Small Business Administration securities permissible under §107(7) of the Act.

State means any one of the several states of the United States of America, the District of Columbia, Puerto Rico, and the territories and possessions of the United States.

Stripped mortgage-backed security means a security that represents either the principal-only or interest-only portion of the cash flows of an underlying pool of mortgages.

Subordinated security means a security that, at the time of purchase, has a junior claim on the underlying collateral or assets to other securities in the same issuance. If a security is junior only to money market fund eligible securities in the same issuance, the former security is not subordinated for purposes of this definition.

Total assets means the sum of all a corporate credit union's assets as calculated under GAAP.

Total capital means the sum of a corporate credit union's core capital and its membership capital accounts.

Trade date means the date a corporate credit union originally agrees, whether orally or in writing, to enter into the purchase or sale of a security.

Trigger means an event in a securitization that will redirect cash-flows if predefined thresholds are breached. Examples of triggers are delinquency and cumulative loss triggers.

Weighted average life means the weighted-average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of principal. The calculation of weighted average life for interest only

securities means the weighted-average time to the return of a dollar of interest, calculated by multiplying each portion of interest received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of interest to be received.

When-issued trading means the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities.

7. Effective [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], revise §704.2 to read as follows:

§ 704.2 Definitions.

Adjusted core capital means core capital modified as follows:

- (1) Deduct an amount equal to the amount of the corporate credit union's intangible assets that exceed one half percent of the corporate credit union's moving daily average net assets, but the NCUA, on its own initiative, upon petition by the applicable state regulator, or upon application from a corporate credit union, may direct that a particular corporate credit union add some or all of these excess intangibles back to the credit union's adjusted core capital;
- (2) Deduct investments, both equity and debt, in unconsolidated credit union service organizations (CUSOs);
- (3) If the corporate credit union, on or after [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], contributes any perpetual contributed capital (PCC), or maintains any NCAs, at another corporate credit union, deduct an amount equal to this PCC or NCA;
- (4) Beginning on [INSERT DATE 72 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], and ending on [INSERT DATE 120 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], deduct any amount of perpetual contributed capital (PCC) that causes PCC minus retained earnings, all divided by moving daily net average assets, to exceed two percent; and
- (5) Beginning after [INSERT DATE 120 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], deduct any amount of PCC that causes PCC to exceed retained earnings.

Adjusted trading means any method or transaction whereby a corporate credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from the vendor another

security at a price above its current market price.

Applicable state regulator means the prudential state regulator of a state chartered corporate credit union.

Asset-backed commercial paper program (ABCP program) means a program that primarily issues commercial paper that has received a credit rating from an NRSRO and that is backed by assets or other exposures held in a bankruptcy-remote special purpose entity. The term sponsor of an ABCP program means a corporate credit union that:

- (1) Establishes an ABCP program;
- (2) Approves the sellers permitted to participate in an ABCP program;
- (3) Approves the asset pools to be purchased by an ABCP program; or
- (4) Administers the ABCP program by monitoring the assets, arranging for debt placement, compiling monthly reports, or ensuring compliance with the program documents and with the program's credit and investment policy.

Asset-backed security (ABS) means a security that is primarily serviced by the cashflows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders. Mortgage-backed securities are a type of asset-backed security.

Available to cover losses that exceed retained earnings means that the funds are available to cover operating losses realized, in accordance with generally accepted accounting principles (GAAP), by the corporate credit union that exceed retained earnings net of equity acquired in a combination. Likewise, available to cover losses that exceed retained earnings and perpetual contributed capital (PCC) means that the funds are available to cover operating losses realized, in accordance with GAAP, by the corporate credit union that exceed retained earnings net of equity acquired in a combination and PCC. Any such losses must be distributed pro rata at the time the loss is realized first among the holders of PCC, and when all PCC is exhausted, then pro rata among all nonperpetual capital accounts (NCAs) and unconverted membership capital accounts, all subject to the optional prioritization described in Appendix A of this Part. To the extent that any contributed capital funds are used to cover losses, the corporate credit union must not restore or replenish the affected capital accounts under any circumstances. In addition, contributed capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

Capital means the same as total capital, defined below.

Capital ratio means the corporate credit union's capital divided by its moving daily average net assets.

Collateralized debt obligation (CDO) means a debt security collateralized by mortgage-backed securities, asset-backed securities, or corporate obligations in the form of loans or debt. Senior tranches of Re-REMIC's consisting of senior mortgage- and asset-backed securities are excluded from this definition.

Collateralized mortgage obligation (CMO) means a multi-class mortgage-backed security.

Commercial mortgage-backed security (CMBS) means a mortgage-backed security collateralized primarily by multi-family and commercial property loans.

Compensation means all salaries, fees, wages, bonuses, severance payments, current year contributions to employee benefit plans (for example, medical, dental, life insurance, and disability), current year contributions to deferred compensation plans and future severance payments, including payments in connection with a merger or similar combination (whether or not funded; whether or not vested; and whether or not the deferred compensation plan is a qualified plan under Section 401(a) of the IRS Code). Compensation also includes expense accounts and other allowances (for example, the value of the personal use of housing, automobiles or other assets owned by the corporate credit union; expense allowances or reimbursements that recipients must report as income on their separate income tax return; payments made under indemnification arrangements; and payments made for the benefit of friends or relatives). In calculating required compensation disclosures, reasonable estimates may be used if precise cost figures are not readily available.

Consolidated Credit Union Service Organization (Consolidated CUSO) means any corporation, partnership, business trust, joint venture, association or similar organization in which a corporate credit union directly or indirectly holds an ownership interest (as permitted by §704.11 of this Part) and the assets of which are consolidated with those of the corporate credit union for purposes of reporting under Generally Accepted Accounting Principles (GAAP). Generally, consolidated CUSOs are majority-owned CUSOs.

Contributed capital means either perpetual or nonperpetual capital.

Core capital means the sum of:

- (1) Retained earnings;
- (2) Perpetual contributed capital;
- (3) The retained earnings of any acquired credit union, or of an integrated set of activities and assets, calculated at the point of acquisition, if the acquisition was a mutual combination; and
- (4) Minority interests in the equity accounts of CUSOs that are fully consolidated. However, minority interests in consolidated ABCP programs sponsored by a corporate credit union are excluded from the credit unions' core capital or total

capital base if the corporate credit union excludes the consolidated assets of such programs from risk-weighted assets pursuant to Appendix C of this Part.

Core capital ratio means the corporate credit union's core capital divided by its moving daily average net assets.

Corporate credit union means an organization that:

- (1) Is chartered under Federal or state law as a credit union;
- (2) Receives shares from and provides loan services to credit unions;
- (3) Is operated primarily for the purpose of serving other credit unions;
- (4) Is designated by NCUA as a corporate credit union;
- (5) Limits natural person members to the minimum required by state or federal law to charter and operate the credit union; and
- (6) Does not condition the eligibility of any credit union to become a member on that credit union's membership in any other organization.

Credit-enhancing interest-only strip means an on-balance sheet asset that, in form or in substance:

- (1) Represents the contractual right to receive some or all of the interest due on transferred assets; and
- (2) Exposes the corporate credit union to credit risk directly or indirectly associated with the transferred assets that exceeds its pro rata share of the corporate credit union's claim on the assets whether through subordination provisions or other credit enhancement techniques.

NCUA reserves the right to identify other cash flows or related interests as a credit-enhancing interest-only strip. In determining whether a particular interest cash flow functions as a credit-enhancing interest-only strip, NCUA will consider the economic substance of the transaction.

Daily average net assets means the average of net assets calculated for each day during the period.

Daily average net risk-weighted assets means the average of net risk-weighted assets calculated for each day during the period.

Derivatives means a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. Derivative contracts include interest rate derivative contracts, exchange rate derivative contracts, equity derivative contracts, commodity derivative contracts, credit derivative contracts, and any other instrument that poses similar counterparty credit risks.

Dollar roll means the purchase or sale of a mortgage-backed security to a counterparty with an agreement to resell or repurchase a substantially identical security at a future date and at a specified price.

Eligible ABCP liquidity facility means a legally binding commitment to provide liquidity support to asset-backed commercial paper by lending to, or purchasing assets from any structure, program or conduit in the event that funds are required to repay maturing asset-backed commercial paper and that meets the following criteria:

(1)(i) At the time of the draw, the liquidity facility must be subject to an asset quality test that precludes funding against assets that are 90 days or more past due or in default; and

(ii) If the assets that the liquidity facility is required to fund against are assets or exposures that have received a credit rating by an NRSRO at the time the inception of the facility, the facility can be used to fund only those assets or exposures that are rated investment grade by an NRSRO at the time of funding; or

(2) If the assets that are funded under the liquidity facility do not meet the criteria described in paragraph (1) of this definition, the assets must be guaranteed, conditionally or unconditionally, by the United States Government, its agencies, or the central government of an Organization for Economic Cooperation and Development (OECD) country.

Embedded option means a characteristic of certain assets and liabilities which gives the issuer of the instrument the ability to change the features such as final maturity, rate, principal amount and average life. Options include, but are not limited to, calls, caps, and prepayment options.

Equity investment means investments in real property, equity securities, and any other ownership interests, including, for example, investments in partnerships and limited liability companies.

Equity security means any security representing an ownership interest in an enterprise (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants and call options) or dispose of (for example, put options) an ownership interest in an enterprise at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor.

Exchangeable collateralized mortgage obligation means a class of a collateralized mortgage obligation (CMO) that, at the time of purchase, represents beneficial ownership interests in a combination of two or more underlying classes of the same CMO structure. The holder of an exchangeable CMO may pay a fee and take delivery of the underlying classes of the CMO.

Fair value means the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. If there is a principal market for the asset or liability, the fair value measurement is the price in that market (whether that price is directly

observable or otherwise determined using a valuation technique), even if the price in a different market is potentially more advantageous at the measurement date. In the absence of a principal market, the fair value measurement occurs in the most advantageous market for the asset or liability. The fair value of the asset or liability shall be determined based on the assumptions that market participants would use in pricing the asset or liability. In developing those assumptions, the corporate need not identify specific market participants. Rather, the corporate should identify characteristics that distinguish market participants generally, considering factors specific to all of the following: a. The asset or liability; b. The principal (or most advantageous) market for the asset or liability; and C. Market participants with whom the corporate would transact in that market. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). Examples of valuation techniques include the present value of estimated future cash flows, option-pricing models, and option-adjusted spread models.

Federal funds transaction means a short-term or open-ended unsecured transfer of immediately available funds by one depository institution to another depository institution or entity.

Foreign bank means an institution which is organized under the laws of a country other than the United States, is engaged in the business of banking, and is recognized as a bank by the banking supervisory authority of the country in which it is organized.

Immediate family member means a spouse or other family member living in the same household.

Intangible assets means assets considered to be intangible assets under GAAP. These assets include, but are not limited to, core deposit premiums, purchased credit card relationships, favorable leaseholds, and servicing assets (mortgage and non-mortgage). Interest-only strips receivable are not intangible assets under this definition.

Leverage ratio means, before [INSERT DATE 36 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], the ratio of total capital to moving daily average net assets. This is the interim leverage ratio.

Leverage ratio means, on or after [INSERT DATE 36 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], the ratio of adjusted core capital to moving daily average net assets. This is the permanent leverage ratio.

Limited liquidity investment means a private placement or funding agreement.

Member reverse repurchase transaction means an integrated transaction in which a corporate credit union purchases a security from one of its member credit unions under agreement by that member credit union to repurchase the same security at a specified time in the future. The corporate credit union then sells that same security, on the same day, to a third party, under agreement to repurchase it on the same date on which the corporate credit union is obligated to return the security to its member credit union.

Mortgage-backed security (MBS) means a security backed by first or second mortgages secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure.

Moving daily average net assets means the average of daily average net assets for the month being measured and the previous eleven (11) months.

Moving monthly average net risk-weighted assets means the average of the net risk-weighted assets for the month being measured and the previous eleven (11) months. Measurements must be taken on the last day of each month.

Mutual combination means a transaction or event in which a corporate credit union acquires another credit union, or acquires an integrated set of activities and assets that is capable of being conducted and managed as a credit union.

Nationally Recognized Statistical Rating Organization (NRSRO) means any entity that has applied for, and been granted permission, to be considered an NRSRO by the United States Securities and Exchange Commission.

NCUA means NCUA Board (Board), unless the particular action has been delegated by the Board.

Net assets means total assets less loans guaranteed by the NCUSIF and member reverse repurchase transactions. For its own account, a corporate credit union's payables under reverse repurchase agreements and receivables under repurchase agreements may be netted out if the GAAP conditions for offsetting are met. Also, any amounts deducted from core capital in calculating adjusted core capital are also deducted from net assets.

Net economic value (NEV) means the fair value of assets minus the fair value of liabilities. All fair value calculations must include the value of forward settlements and embedded options. Perpetual contributed capital, and the unamortized portion of nonperpetual capital that is, the portion that qualifies as capital for purposes of any of the minimum capital ratios, is excluded from

liabilities for purposes of this calculation. The NEV ratio is calculated by dividing NEV by the fair value of assets.

Net interest margin security means a security collateralized by residual interests in collateralized mortgage obligations, residual interests in real estate mortgage investment conduits, or residual interests in other asset-backed securities.

Net risk-weighted assets means risk-weighted assets less Central Liquidity Facility (CLF) stock subscriptions, CLF loans guaranteed by the NCUSIF, and member reverse repurchase transactions. For its own account, a corporate credit union's payables under reverse repurchase agreements and receivables under repurchase agreements may be netted out if the GAAP conditions for offsetting are met. Also, any amounts deducted from core capital in calculating adjusted core capital are also deducted from net risk-weighted assets.

Nonperpetual capital means funds contributed by members or nonmembers that: are term certificates with an original minimum term of five years or that have an indefinite term (i.e., no maturity) with a minimum withdrawal notice of five years; are available to cover losses that exceed retained earnings and perpetual contributed capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings. In the event the corporate is liquidated, the holders of nonperpetual capital accounts (NCAs) will claim equally. These claims will be subordinate to all other claims (including NCUSIF claims), except that any claims by the holders of perpetual contributed capital (PCC) will be subordinate to the claims of holders of NCAs.

Obligor means the primary party obligated to repay an investment, e.g., the issuer of a security, such as a Qualified Special Purpose Entity (QSPE) trust; the taker of a deposit; or the borrower of funds in a federal funds transaction. Obligor does not include an originator of receivables underlying an asset-backed security, the servicer of such receivables, or an insurer of an investment.

Official means any director or committee member.

Pair-off transaction means a security purchase transaction that is closed out or sold at, or prior to, the settlement or expiration date.

Perpetual contributed capital (PCC) means accounts or other interests of a corporate credit union that: are perpetual, non-cumulative dividend accounts; are available to cover losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings. In the event the corporate is liquidated, any claims made by the holders of perpetual contributed capital will be subordinate to all other claims (including NCUSIF claims).

Private label security means a security that is not issued or guaranteed by the U.S. government, its agencies, or its government-sponsored enterprises (GSEs).

Quoted market price means a recent sales price or a price based on current bid and asked quotations.

Repurchase transaction means a transaction in which a corporate credit union agrees to purchase a security from a counterparty and to resell the same or any identical security to that counterparty at a specified future date and at a specified price.

Residential properties means houses, condominiums, cooperative units, and manufactured homes. This definition does not include boats or motor homes, even if used as a primary residence, or timeshare properties.

Residential mortgage-backed security (RMBS) means a mortgage-backed security collateralized primarily by mortgage loans on residential properties.

Residual interest means the ownership interest in remainder cash flows from a CMO or ABS transaction after payments due bondholders and trust administrative expenses have been satisfied.

Retained earnings means retained earnings as defined under Generally Accepted Accounting Principles (GAAP).

Risk-weighted assets means a corporate credit union's risk-weighted assets as calculated in accordance with Appendix C of this part.

Section 107(8) institution means an institution described in Section 107(8) of the Federal Credit Union Act (12 U.S.C. 1757(8)).

Securities lending means lending a security to a counterparty, either directly or through an agent, and accepting collateral in return.

Securitization means the pooling and repackaging by a special purpose entity of assets or other credit exposures that can be sold to investors. Securitization includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

Senior executive officer means a chief executive officer, any assistant chief executive officer (e.g., any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller). This term also includes employees of any entity hired to perform the functions described above.

Settlement date means the date originally agreed to by a corporate credit union and a counterparty for settlement of the purchase or sale of a security.

Short sale means the sale of a security not owned by the seller.

Small business related security means a security that is rated in 1 of the 4 highest rating categories by at least one nationally recognized statistical rating organization, and represents an interest in one or more promissory notes or leases of personal property evidencing the obligation of a small business concern and originated by an insured depository institution, insured credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or a finance company or leasing company. This definition does not include Small Business Administration securities permissible under § 107(7) of the Act.

State means any one of the several states of the United States of America, the District of Columbia, Puerto Rico, and the territories and possessions of the United States.

Stripped mortgage-backed security means a security that represents either the principal-only or interest-only portion of the cash flows of an underlying pool of mortgages.

Subordinated security means a security that, at the time of purchase, has a junior claim on the underlying collateral or assets to other securities in the same issuance. If a security is junior only to money market fund eligible securities in the same issuance, the former security is not subordinated for purposes of this definition.

Supplementary Capital means the sum of the following items:

- (1) Nonperpetual capital accounts, as amortized under §704.3(b)(3);
- (2) Allowance for loan and lease losses calculated under GAAP to a maximum of 1.25 percent of risk-weighted assets; and
- (3) Forty-five percent of unrealized gains on available-for-sale equity securities with readily determinable fair values. Unrealized gains are unrealized holding gains, net of unrealized holding losses, calculated as the amount, if any, by which fair value exceeds historical cost. The NCUA may disallow such inclusion in the calculation of supplementary capital if the NCUA determines that the securities are not prudently valued.

Tier 1 capital means adjusted core capital.

Tier 2 capital means supplementary capital plus any perpetual contributed capital deducted from adjusted core capital.

Tier 1 risk-based capital ratio means the ratio of Tier 1 capital to the moving monthly average net risk-weighted assets.

Total assets means the sum of all a corporate credit union's assets as calculated under GAAP.

Total capital means the sum of a corporate credit union's adjusted core capital and its supplementary capital, less the corporate credit union's equity investments not otherwise deducted when calculating adjusted core capital.

Total risk-based capital ratio means the ratio of total capital to moving monthly average net risk-weighted assets.

Trade date means the date a corporate credit union originally agrees, whether orally or in writing, to enter into the purchase or sale of a security.

Trigger means an event in a securitization that will redirect cash-flows if predefined thresholds are breached. Examples of triggers are delinquency and cumulative loss triggers.

Weighted average life means the weighted-average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of principal. The calculation of weighted average life for interest only securities means the weighted-average time to the return of a dollar of interest, calculated by multiplying each portion of interest received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time) and then summing and dividing by the total amount of interest to be received.

When-issued trading means the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities.

8. Effective [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], revise §704.3 to read as follows:

§704.3 Corporate credit union capital.

(a) Capital requirements. (1) A corporate credit union must maintain at all times:

- (i) A leverage ratio of 4.0 percent or greater;
- (ii) A Tier 1 risk-based capital ratio of 4.0 percent or greater; and
- (iii) A total risk-based capital ratio of 8.0 percent or greater.

(2) To ensure it meets its capital requirements, a corporate credit union must develop and ensure implementation of written short- and long-term capital goals, objectives, and strategies which provide for the building of capital consistent with regulatory requirements, the maintenance of sufficient capital to support the risk exposures that may arise from current and projected activities, and the periodic review and reassessment of the capital position of the corporate credit union.

(3) Beginning with the first call report submitted on or after [INSERT DATE 36 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], a

corporate credit union must calculate and report to NCUA the ratio of its retained earnings to its moving daily average net assets. If this ratio is less than 0.45 percent, the corporate credit union must, within 30 days, submit a retained earnings accumulation plan to the NCUA for NCUA's approval. The plan must contain a detailed explanation of how the corporate credit union will accumulate earnings sufficient to meet all its future minimum leverage ratio requirements, including specific semiannual milestones for accumulating retained earnings. In the case of a state-chartered corporate credit union, the NCUA will consult with the appropriate state supervisory authority (SSA) before making a determination to approve or disapprove the plan, and will provide the SSA a copy of the completed plan. If the corporate credit union fails to submit a plan acceptable to NCUA, or fails to comply with any element of a plan approved by NCUA, the corporate will immediately be classified as significantly undercapitalized or, if already significantly undercapitalized, as critically undercapitalized for purposes of prompt corrective actions. The corporate credit union will be subject to all the associated actions under §704.4.

(b) Requirements for nonperpetual capital accounts (NCAs) -- (1) Form. NCA funds may be in the form of a term certificate or a no-maturity notice account.

(2) Disclosure. The terms and conditions of a nonperpetual capital account must be disclosed to the recorded owner of the account at the time the account is opened and at least annually thereafter.

(i) The initial NCA disclosure must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board; and

(ii) The annual disclosure notice must be signed by the chair of the corporate credit union. The chair must sign a statement that certifies that the notice has been sent to all entities with NCAs. The certification must be maintained in the corporate credit union's files and be available for examiner review.

(3) Five-year remaining maturity. When a no-maturity NCA has been placed on notice, or a term account has a remaining maturity of less than five years, the corporate will reduce the amount of the account that can be considered as nonperpetual capital by a constant monthly amortization that ensures the capital is fully amortized one year before the date of maturity or one year before the end of the notice period. The full balance of an NCA being amortized, not just the remaining non-amortized portion, is available to absorb losses in excess of the sum of retained earnings and perpetual contributed capital until the funds are released by the corporate credit union at the time of maturity or the conclusion of the notice period.

(4) Release. Nonperpetual capital may not be released due solely to the merger, charter conversion, or liquidation of the account holder. In the event of a merger, the capital account transfers to the continuing entity. In the event of a charter conversion, the capital account transfers to the new institution. In the event of liquidation, the corporate may release a member capital account to facilitate the payout of shares, but only with the prior written approval of the NCUA.

(5) Redemption. A corporate credit union may redeem NCAs prior to maturity or prior to the end of the notice period only with the prior approval of the NCUA and, for state chartered corporate credit unions, the approval of the appropriate state regulator.

(6) Sale. A member may transfer its interest in a nonperpetual capital account to another member or to a nonmember (other than a natural person). At least 14 days before consummating such a transfer, the member must notify the corporate credit union of the pending transfer. The corporate credit union must, within 10 days of such notice, provide the member and the potential transferee all financial information about the corporate credit union that is available to the public or that the corporate credit union has provided to its members, including any call report data submitted by the corporate credit union to NCUA but not yet posted on NCUA's website.

(7) Merger. In the event of a merger of a corporate credit union, nonperpetual capital will transfer to the continuing corporate credit union. The minimum five-year notice period for withdrawal of no-maturity capital remains in effect.

(c) Requirements for perpetual contributed capital (PCC) -- (1) Disclosure. The terms and conditions of any perpetual contributed capital instrument must be disclosed to the recorded owner of the instrument at the time the instrument is created and must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board.

(2) Release. Perpetual contributed capital may not be released due solely to the merger, charter conversion or liquidation of a member credit union. In the event of a merger, the perpetual contributed capital transfers to the continuing credit union. In the event of a charter conversion, the perpetual contributed capital transfers to the new institution. In the event of liquidation, the perpetual contributed capital may be released to facilitate the payout of shares with NCUA's prior written approval.

(3) Callability. A corporate credit union may call perpetual contributed capital instruments only with the prior approval of the NCUA and, for state chartered

corporate credit unions, the applicable state regulator. Perpetual contributed capital accounts are callable on a pro-rata basis across an issuance class.

(4) Perpetual contributed capital. A corporate credit union may issue perpetual contributed capital to both members and nonmembers.

(5) The holder of a PCC instrument may transfer its interests in the instrument to another member or to a nonmember (other than a natural person). At least 14 days before consummating such a transfer, the member must notify the corporate credit union of the pending transfer. The corporate credit union must, within 10 days of such notice, provide the member and the potential transferee all financial information about the corporate credit union that is available to the public or that the corporate credit union has provided to its members, including any call report data submitted by the corporate credit union to NCUA but not yet posted on NCUA's website.

(6) A corporate credit union is permitted to condition membership, services, or prices for services on a member's ownership of PCC, provided the corporate credit union gives existing members at least six months written notice of

(i) The requirement to purchase PCC, including specific amounts; and

(ii) The effects of a failure to purchase the requisite PCC on the pricing of services or on the member's access to membership or services.

(d) Individual minimum capital requirements.

(1) General. The rules and procedures specified in this paragraph apply to the establishment of an individual minimum capital requirement for a corporate credit union that varies from any of the risk-based capital requirement(s) or leverage ratio requirements that would otherwise apply to the corporate credit union under this part.

(2) Appropriate considerations for establishing individual minimum capital requirements. Minimum capital levels higher than the risk-based capital requirements or the leverage ratio requirement under this part may be appropriate for individual corporate credit unions. The NCUA may establish increased individual minimum capital requirements, including modification of the minimum capital requirements related to being either significantly and critically undercapitalized for purposes of §704.4 of this part, upon a determination that the corporate credit union's capital is or may become inadequate in view of the credit union's circumstances. For example, higher capital levels may be

appropriate when NCUA determines that:

- (i) A corporate credit union is receiving special supervisory attention;
- (ii) A corporate credit union has or is expected to have losses resulting in capital inadequacy;
- (iii) A corporate credit union has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration risk, certain risks arising from nontraditional activities or similar risks, or a high proportion of off-balance sheet risk including standby letters of credit;
- (iv) A corporate credit union has poor liquidity or cash flow;
- (v) A corporate credit union is growing, either internally or through acquisitions, at such a rate that supervisory problems are presented that are not dealt with adequately by other NCUA regulations or other guidance;
- (vi) A corporate credit union may be adversely affected by the activities or condition of its CUSOs or other persons or entities with which it has significant business relationships, including concentrations of credit;
- (vii) A corporate credit union with a portfolio reflecting weak credit quality or a significant likelihood of financial loss, or has loans or securities in nonperforming status or on which borrowers fail to comply with repayment terms;
- (viii) A corporate credit union has inadequate underwriting policies, standards, or procedures for its loans and investments;
- (ix) A corporate credit union has failed to properly plan for, or execute, necessary retained earnings growth, or
- (ix) A corporate credit union has a record of operational losses that exceeds the average of other, similarly situated corporate credit unions; has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly the risks presented by concentrations of credit and nontraditional activities; or has a poor record of supervisory compliance.

(3) Standards for determination of appropriate individual minimum capital requirements. The appropriate minimum capital levels for an individual corporate credit union cannot be determined solely through the application of a rigid mathematical formula or wholly objective criteria. The decision is necessarily based, in part, on subjective judgment grounded in agency expertise.

The factors to be considered in NCUA's determination will vary in each case and may include, for example:

- (i) The conditions or circumstances leading to the determination that a higher minimum capital requirement is appropriate or necessary for the corporate credit union;
- (ii) The exigency of those circumstances or potential problems;
- (iii) The overall condition, management strength, and future prospects of the corporate credit union and, if applicable, its subsidiaries, affiliates, and business partners;
- (iv) The corporate credit union's liquidity, capital and other indicators of financial stability, particularly as compared with those of similarly situated corporate credit unions; and
- (v) The policies and practices of the corporate credit union's directors, officers, and senior management as well as the internal control and internal audit systems for implementation of such adopted policies and practices.

(4) Procedures -- (i) In the case of a state chartered corporate credit union, NCUA will consult with the appropriate state regulator when considering imposing a new minimum capital requirement.

(ii) When the NCUA determines that a minimum capital requirement is necessary or appropriate for a particular corporate credit union, it will notify the corporate credit union in writing of its proposed individual minimum capital requirement; the schedule for compliance with the new requirement; and the specific causes for determining that the higher individual minimum capital requirement is necessary or appropriate for the corporate credit union. The NCUA shall forward the notifying letter to the appropriate state supervisory authority (SSA) if a state-chartered corporate credit union would be subject to an individual minimum capital requirement.

(iii) The corporate credit union's response must include any information that the credit union wants the NCUA to consider in deciding whether to establish or to amend an individual minimum capital requirement for the corporate credit union, what the individual capital requirement should be, and, if applicable, what compliance schedule is appropriate for achieving the required capital level. The responses of the corporate credit union and SSA must be in writing and must be delivered to the NCUA within 30 days after the date on which the notification was received. The NCUA may extend the time period for good cause, and the time period for response by the insured corporate credit union may be shortened for

good cause:

(A) When, in the opinion of the NCUA, the condition of the corporate credit union so requires, and the NCUA informs the corporate credit union of the shortened response period in the notice;

(B) With the consent of the corporate credit union; or

(C) When the corporate credit union already has advised the NCUA that it cannot or will not achieve its applicable minimum capital requirement.

(iv) Failure by the corporate credit union to respond within 30 days, or such other time period as may be specified by the NCUA, may constitute a waiver of any objections to the proposed individual minimum capital requirement or to the schedule for complying with it, unless the NCUA has provided an extension of the response period for good cause.

(v) After expiration of the response period, the NCUA will decide whether or not the proposed individual minimum capital requirement should be established for the corporate credit union, or whether that proposed requirement should be adopted in modified form, based on a review of the corporate credit union's response and other relevant information. The NCUA's decision will address comments received within the response period from the corporate credit union and the appropriate state supervisory authority (SSA) (if a state-chartered corporate credit union is involved) and will state the level of capital required, the schedule for compliance with this requirement, and any specific remedial action the corporate credit union could take to eliminate the need for continued applicability of the individual minimum capital requirement. The NCUA will provide the corporate credit union and the appropriate SSA (if a state-chartered corporate credit union is involved) with a written decision on the individual minimum capital requirement, addressing the substantive comments made by the corporate credit union and setting forth the decision and the basis for that decision. Upon receipt of this decision by the corporate credit union, the individual minimum capital requirement becomes effective and binding upon the corporate credit union. This decision represents final agency action.

(vi) In lieu of the procedures established above, a corporate credit union may request an informal hearing. The corporate credit union must make the request for a hearing in writing, and NCUA must receive the request no later than 10 days following the date of the notice described in paragraph (ii) above. Upon receipt of the request for hearing, NCUA will conduct an informal hearing and render a decision using the procedures described in paragraphs (d), (e), and (f) of Section 747.3003 of this chapter.

(4) Failure to comply. Failure to satisfy any individual minimum capital requirement, or to meet any required incremental additions to capital under a schedule for compliance with such an individual minimum capital requirement, will constitute a basis to take action as described in §704.4.

(5) Change in circumstances. If, after a decision is made under paragraph (b)(3)(iv) of this section, there is a change in the circumstances affecting the corporate credit union's capital adequacy or its ability to reach its required minimum capital level by the specified date, the NCUA may amend the individual minimum capital requirement or the corporate credit union's schedule for such compliance. The NCUA may decline to consider a corporate credit union's request for such changes that are not based on a significant change in circumstances or that are repetitive or frivolous. Pending the NCUA's reexamination of the original decision, that original decision and any compliance schedule established in that decision will continue in full force and effect.

(e) Reservation of authority.

(1) Transactions for purposes of evasion. The NCUA may disregard any transaction entered into primarily for the purpose of reducing the minimum required amount of regulatory capital or otherwise evading the requirements of this section.

(2) Period-end versus average figures. The NCUA reserves the right to require a corporate credit union to compute its capital ratios on the basis of period-end assets rather than average assets when the NCUA determines this requirement is appropriate to carry out the purposes of this part.

(3) Reservation of authority. (i) Notwithstanding the definitions of core and supplementary capital in paragraph (d) of this section, the NCUA may find that a particular asset or core or supplementary capital component has characteristics or terms that diminish its contribution to a corporate credit union's ability to absorb losses, and the NCUA may require the discounting or deduction of such asset or component from the computation of core, supplementary, or total capital.

(ii) Notwithstanding Appendix C of this Part, the NCUA will look to the substance of a transaction and may find that the assigned risk-weight for any asset, or credit equivalent amount or credit conversion factor for any off-balance sheet item does not appropriately reflect the risks imposed on the corporate credit union. The NCUA may require the corporate credit union to apply another risk-weight, credit equivalent amount, or credit conversion factor that NCUA deems appropriate.

(iii) If Appendix C does not specifically assign a risk-weight, credit equivalent

amount, or credit conversion factor to a particular asset or activity of the corporate credit union, the NCUA may assign any risk-weight, credit equivalent amount, or credit conversion factor that it deems appropriate. In making this determination, NCUA will consider the risks associated with the asset or off-balance sheet item as well as other relevant factors.

(4) Where practicable, the NCUA will consult with the appropriate state regulator before taking any action under this paragraph (e) that involves a state chartered corporate credit union.

(5) Before taking any action under this paragraph (e), NCUA will provide the corporate credit union with written notice of the intended action and the reasons for such action. The corporate credit union will have seven days to provide the NCUA with a written response, and the NCUA will consider the response before taking the action. Upon the timely request of the corporate credit union, and for good cause, NCUA may extend the seven day response period.

(f) *Former capital accounts.* This paragraph addresses membership capital accounts (MCAs) that qualified as corporate capital prior to [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER ] but which no longer satisfy the definitions of capital because the accounts have not been converted by the member to nonperpetual capital accounts (NCAs) or to perpetual contributed capital (PCC).

(1) For MCAs structured as adjustable balance accounts, the corporate will immediately place the account on notice of withdrawal if the member has not already done so. The corporate will continue to adjust the balance of the MCA account in accordance with the original terms of the account until the entire notice period has run and then return the remaining balance, less any losses, to the member. Until the expiration of the notice period the entire adjusted balance will be available to cover losses at the corporate credit union that exceed retained earnings and PCC (excluding, if a corporate credit union exercises the capital prioritization option under Part I of Appendix A, any PCC with priority under that option).

(2) For term MCAs, the corporate credit union will return the balance of the MCA account to the member at the expiration of the term. Until the expiration of term, the entire account balance will be available to cover losses that exceed retained earnings and PCC (excluding, if a corporate credit union exercises the capital prioritization option under Part I of Appendix A, any PCC with priority under that option).

(3) A corporate credit union may count a portion of unconverted MCAs as Tier 2 capital. Beginning on the date of issuance (for term MCAs) or the date of notice of withdrawal (for other MCAs), the corporate may count the entire account balance as Tier 2 capital, but will then reduce the amount of the account that can

be considered as Tier 2 capital by a constant monthly amortization that ensures the capital is fully amortized one year before the date of maturity or one year before the end of the notice period. For adjustable balance account MCAs where the adjustment is determined based on some impermanent measure, such as shares on deposit with the corporate, the corporate credit union may not treat any part of the account as capital.

(4) A corporate credit union must, on or before [INSERT DATE 14 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], provide any members that hold unconverted MCAs a one-time written disclosure about the status of their MCA accounts as described in this paragraph (f).

9. Redesignate §704.4, Board responsibilities, as §704.13.

10. Effective [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER}, add a new §704.4 to read as follows:

§ 704.4. Prompt Corrective Action.

(a) Purpose. The principal purpose of this section is to define, for corporate credit unions that are not adequately capitalized, the capital measures and capital levels that are used for determining appropriate supervisory actions. This section establishes procedures for submission and review of capital restoration plans and for issuance and review of capital directives, orders, and other supervisory directives.

(b) Scope. This section applies to corporate credit unions, including officers, directors, and employees.

(1) This section does not limit the authority of NCUA in any way to take supervisory actions to address unsafe or unsound practices, deficient capital levels, violations of law, unsafe or unsound conditions, or other practices. The NCUA may take action under this section independently of, in conjunction with, or in addition to any other enforcement action available to the NCUA, including issuance of cease and desist orders, approval or denial of applications or notices, assessment of civil money penalties, or any other actions authorized by law.

(2) Unless permitted by the NCUA or otherwise required by law, no corporate credit union may state in any advertisement or promotional material its capital category under this part or that the NCUA has assigned the corporate credit union to a particular category.

(3) Any group of credit unions applying for a new corporate credit union charter will submit, as part of the charter application, a detailed draft plan for soliciting

contributed capital and building retained earnings. The draft plan will include specific levels of contributed capital and retained earnings and the anticipated timeframes for achieving those levels. The Board will review the draft plan and modify it as necessary. If the Board approves the plan, the Board will include any necessary waivers of this section or part.

(c) Notice of capital category. (1) Effective date of determination of capital category. A corporate credit union will be deemed to be within a given capital category as of the most recent date:

- (i) A 5310 Financial Report is required to be filed with the NCUA;
- (ii) A final NCUA report of examination is delivered to the corporate credit union;
- or
- (iii) Written notice is provided by the NCUA to the corporate credit union that its capital category has changed as provided in paragraphs (c)(2) or (d)(3) of this section.

(2) Adjustments to reported capital levels and category —

(i) Notice of adjustment by corporate credit union. A corporate credit union must provide the NCUA with written notice that an adjustment to the corporate credit union's capital category may have occurred no later than 15 calendar days following the date that any material event has occurred that would cause the corporate credit union to be placed in a lower capital category from the category assigned to the corporate credit union for purposes of this section on the basis of the corporate credit union's most recent call report or report of examination.

(ii) Determination by the NCUA to change capital category. After receiving notice pursuant to paragraph (c)(1) of this section, or on its own initiative, the NCUA will determine whether to change the capital category of the corporate credit union and will notify the corporate credit union of the NCUA's determination.

(d) Capital measures and capital category definitions. (1) Capital measures. For purposes of this section, the relevant capital measures are:

- (i) The total risk-based capital ratio;
- (ii) The Tier 1 risk-based capital ratio; and
- (iii) The leverage ratio.

(2) Capital categories. For purposes of this section, a corporate credit union is:

- (i) Well capitalized if the corporate credit union:
  - (A) Has a total risk-based capital ratio of 10.0 percent or greater; and
  - (B) Has a Tier 1 risk-based capital ratio of 6.0 percent or greater; and

- (C) Has a leverage ratio of 5.0 percent or greater; and
- (D) Is not subject to any written agreement, order, capital directive, or prompt corrective action directive issued by NCUA to meet and maintain a specific capital level for any capital measure.

(ii) Adequately capitalized if the corporate credit union:

- (A) Has a total risk-based capital ratio of 8.0 percent or greater; and
- (B) Has a Tier 1 risk-based capital ratio of 4.0 percent or greater; and
- (C) Has:
  - (1) A leverage ratio of 4.0 percent or greater; and
  - (2) Does not meet the definition of a well capitalized corporate credit union.

(iii) Undercapitalized if the corporate credit union:

- (A) Has a total risk-based capital ratio that is less than 8.0 percent; or
- (B) Has a Tier 1 risk-based capital ratio that is less than 4.0 percent; or
- (C) Has a leverage ratio that is less than 4.0 percent.

(iv) Significantly undercapitalized if the corporate credit union has:

- (A) A total risk-based capital ratio that is less than 6.0 percent; or
- (B) A Tier 1 risk-based capital ratio that is less than 3.0 percent; or
- (C) A leverage ratio that is less than 3.0 percent.

(v) Critically undercapitalized if the corporate credit union has:

- (A) A total risk-based capital ratio that is less than 4.0 percent; or
- (B) A Tier 1 risk-based capital ratio that is less than 2.0 percent; or
- (C) A leverage ratio that is less than 2.0 percent.

(3) Reclassification based on supervisory criteria other than capital.

Notwithstanding the elements of paragraph (d)(2) of this section, the NCUA may reclassify a well capitalized corporate credit union as adequately capitalized, and may require an adequately capitalized or undercapitalized corporate credit union to comply with certain mandatory or discretionary supervisory actions as if the corporate credit union were in the next lower capital category, in the following circumstances:

(i) Unsafe or unsound condition. The NCUA has determined, after notice and opportunity for hearing pursuant to paragraph (h)(1) of this section, that the corporate credit union is in an unsafe or unsound condition; or

(ii) Unsafe or unsound practice. The NCUA has determined, after notice and an opportunity for hearing pursuant to paragraph (h)(1) of this section, that the

corporate credit union received a less-than-satisfactory rating (i.e., three or lower) for any rating category (other than in a rating category specifically addressing capital adequacy) under the Corporate Risk Information System (CRIS) rating system and has not corrected the conditions that served as the basis for the less than satisfactory rating. Ratings under this paragraph (d)(3)(ii) refer to the most recent ratings (as determined either on-site or off-site by the most recent examination) of which the corporate credit union has been notified in writing.

(4) The NCUA may, for good cause, modify any of the percentages in paragraph (d)(2) of this section as described in §704.3(d).

(e) Capital restoration plans. (1) Schedule for filing plan—

(i) In general. A corporate credit union must file a written capital restoration plan with the NCUA within 45 days of the date that the corporate credit union receives notice or is deemed to have notice that the corporate credit union is undercapitalized, significantly undercapitalized, or critically undercapitalized, unless the NCUA notifies the corporate credit union in writing that the plan is to be filed within a different period. An adequately capitalized corporate credit union that has been required pursuant to paragraph (d)(3) of this section to comply with supervisory actions as if the corporate credit union were undercapitalized is not required to submit a capital restoration plan solely by virtue of the reclassification.

(ii) Additional capital restoration plans. Notwithstanding paragraph (e)(1)(i) of this section, a corporate credit union that has already submitted and is operating under a capital restoration plan approved under this section is not required to submit an additional capital restoration plan based on a revised calculation of its capital measures or a reclassification of the institution under paragraph (d)(3) of this section unless the NCUA notifies the corporate credit union that it must submit a new or revised capital plan. A corporate credit union that is notified that it must submit a new or revised capital restoration plan must file the plan in writing with the NCUA within 45 days of receiving such notice, unless the NCUA notifies the corporate credit union in writing that the plan is to be filed within a different period.

(2) Contents of plan. All financial data submitted in connection with a capital restoration plan must be prepared in accordance with the instructions provided on the call report, unless the NCUA instructs otherwise. The capital restoration plan must include all of the information required to be filed under paragraph

(k)(2)(ii) of this section. A corporate credit union required to submit a capital restoration plan as the result of a reclassification of the corporate credit union pursuant to paragraph (d)(3) of this section must include a description of the steps the corporate credit union will take to correct the unsafe or unsound condition or practice.

(3) Failure to submit a capital restoration plan. A corporate credit union that is undercapitalized and that fails to submit a written capital restoration plan within the period provided in this section will, upon the expiration of that period, be subject to all of the provisions of this section applicable to significantly undercapitalized credit unions.

(4) Review of capital restoration plans. Within 60 days after receiving a capital restoration plan under this section, the NCUA will provide written notice to the corporate credit union of whether it has approved the plan. The NCUA may extend this time period.

(5) Disapproval of capital plan. If the NCUA does not approve a capital restoration plan, the corporate credit union must submit a revised capital restoration plan, when directed to do so, within the time specified by the NCUA. An undercapitalized corporate credit union is subject to the provisions applicable to significantly undercapitalized credit unions until it has submitted, and NCUA has approved, a capital restoration plan. If the NCUA directs that the corporate submit a revised plan, it must do so in time frame specified by the NCUA.

(6) Failure to implement a capital restoration plan. Any undercapitalized corporate credit union that fails in any material respect to implement a capital restoration plan will be subject to all of the provisions of this section applicable to significantly undercapitalized institutions.

(7) Amendment of capital plan. A corporate credit union that has filed an approved capital restoration plan may, after prior written notice to and approval by the NCUA, amend the plan to reflect a change in circumstance. Until such time as NCUA has approved a proposed amendment, the corporate credit union must implement the capital restoration plan as approved prior to the proposed amendment.

(f) Mandatory and discretionary supervisory actions. (1) Mandatory supervisory actions. —

(i) Provisions applicable to all corporate credit unions. All corporate credit unions are subject to the restrictions contained in paragraph (k)(1) of this section on capital distributions.

(ii) Provisions applicable to undercapitalized, significantly undercapitalized, and critically undercapitalized corporate credit unions. Immediately upon receiving notice or being deemed to have notice, as provided in paragraph (c) or (e) of this section, that the corporate credit union is undercapitalized, significantly undercapitalized, or critically undercapitalized, the corporate credit union will be subject to the following provisions of paragraph (k) of this section:

(A) Restricting capital distributions (paragraph (k)(1));

(B) NCUA monitoring of the condition of the corporate credit union (paragraph (k)(2)(i));

(C) Requiring submission of a capital restoration plan (paragraph (k)(2)(ii));

(D) Restricting the growth of the corporate credit union's assets (paragraph (k)(2)(iii)); and

(E) Requiring prior approval of certain expansion proposals (paragraph (k)(2)(iv)).

(iii) Additional provisions applicable to significantly undercapitalized, and critically undercapitalized corporate credit unions. In addition to the mandatory requirements described in paragraph (f)(1) of this section, immediately upon receiving notice or being deemed to have notice that the corporate credit union is significantly undercapitalized, or critically undercapitalized, or that the corporate credit union is subject to the provisions applicable to corporate credit unions that are significantly undercapitalized because the credit union failed to submit or implement in any material respect an acceptable capital restoration plan, the corporate credit union will become subject to the provisions of paragraph (k)(3)(iii) of this section that restrict compensation paid to senior executive officers of the institution.

(iv) Additional provisions applicable to critically undercapitalized corporate credit unions. In addition to the provisions described in paragraphs (f)(1)(ii) and (f)(1)(iii) of this section, immediately upon receiving notice or being deemed to have notice that the corporate credit union is critically undercapitalized, the corporate credit union will become subject to these additional provisions of paragraph (k) of this section:

(A) Restricting the activities of the corporate credit union ((k)(5)(i)); and

(B) Restricting payments on subordinated debt of the corporate credit union ((k)(5)(ii)).

(2) Discretionary supervisory actions.

(i) All PCA actions listed in paragraph (k) of this section that are not discussed in paragraph (f)(1) of this section are discretionary.

(ii) All discretionary actions available to NCUA in the case of an undercapitalized corporate credit union are available to NCUA in the case of a significantly undercapitalized credit union. All discretionary actions available to NCUA in the case of an undercapitalized corporate credit union or a significantly undercapitalized corporate credit union are available to NCUA in the case of a critically undercapitalized corporate credit union.

(iii) In taking any discretionary PCA actions with a corporate credit union that is deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, or has been reclassified as undercapitalized, or significantly undercapitalized; or an action in connection with an officer or director of such corporate credit union; the NCUA will follow the procedures for issuing directives under paragraphs (g) and (i) of this section.

(iv) NCUA will consult and seek to work cooperatively with the appropriate state supervisory authority (SSA) before taking any discretionary supervisory action with respect to a state-chartered corporate credit union; will provide notice of its decision to the SSA; and will allow the appropriate SSA an opportunity to take the proposed action independently or jointly with NCUA.

(g) Directives to take prompt corrective action. The NCUA will provide an undercapitalized, significantly undercapitalized, or critically undercapitalized corporate credit union prior written notice of the NCUA's intention to issue a directive requiring such corporate credit union to take actions or to follow proscriptions described in this part. Section 747.3002 of this chapter prescribes the notice content and associated process.

(h) Procedures for reclassifying a corporate credit union based on criteria other than capital. When the NCUA intends to reclassify a corporate credit union or subject it to the supervisory actions applicable to the next lower capitalization category based on an unsafe or unsound condition or practice, the NCUA will provide the credit union with prior written notice of such intent. Section 747.3003 of this chapter prescribes the notice content and associated process.

(i) Order to dismiss a Director or senior executive officer. When the NCUA issues and serves a directive on a corporate credit union requiring it to dismiss from office any director or senior executive officer under paragraphs (k)(3) of this section, the NCUA will also serve upon the person the corporate credit union is directed to dismiss (Respondent) a copy of the directive (or the relevant portions,

where appropriate) and notice of the Respondent's right to seek reinstatement. Section 747.3004 of this chapter prescribes the content of the notice of right to seek reinstatement and the associated process.

(j) Enforcement of directives. Section 747.3005 of this chapter prescribes the process for enforcement of directives.

(k) Remedial actions towards undercapitalized, significantly undercapitalized, and critically undercapitalized corporate credit unions. (1) Provision applicable to all corporate credit unions. A corporate credit union is prohibited from making any capital distribution, including payment of dividends on perpetual and nonperpetual capital accounts, if, after making the distribution, the credit union would be undercapitalized.

(2) Provisions applicable to undercapitalized corporate credit unions.

(i) Monitoring required. The NCUA will--

(A) Closely monitor the condition of any undercapitalized corporate credit union;

(B) Closely monitor compliance with capital restoration plans, restrictions, and requirements imposed under this section; and

(C) Periodically review the plan, restrictions, and requirements applicable to any undercapitalized corporate credit union to determine whether the plan, restrictions, and requirements are achieving the purpose of this section.

(ii) Capital restoration plan required.

(A) Any undercapitalized corporate credit union must submit an acceptable capital restoration plan to the NCUA.

(B) The capital restoration plan will--

(1) Specify--

(i) The steps the corporate credit union will take to become adequately capitalized;

(ii) The levels of capital to be attained during each year in which the plan will be in effect;

(iii) How the corporate credit union will comply with the restrictions or requirements then in effect under this section; and

(iv) The types and levels of activities in which the corporate credit union will engage; and

(2) Contain such other information as the NCUA may require.

(C) The NCUA will not accept a capital restoration plan unless the NCUA determines that the plan--

(1) Complies with paragraph (k)(2)(ii)(B) of this section;

(2) Is based on realistic assumptions, and is likely to succeed in restoring the corporate credit union's capital; and

(3) Would not appreciably increase the risk (including credit risk, interest-rate risk, and other types of risk) to which the corporate credit union is exposed.

(iii) Asset growth restricted. An undercapitalized corporate credit union must not permit its daily average net assets during any calendar month to exceed its moving daily average net assets unless—

(A) The NCUA has accepted the corporate credit union's capital restoration plan; and

(B) Any increase in total assets is consistent with the plan.

(iv) Prior approval required for acquisitions, branching, and new lines of business. An undercapitalized corporate credit union must not, directly or indirectly, acquire any interest in any entity, establish or acquire any additional branch office, or engage in any new line of business unless the NCUA has accepted the corporate credit union's capital restoration plan, the corporate credit union is implementing the plan, and the NCUA determines that the proposed action is consistent with and will further the achievement of the plan.

(3) Provisions applicable to significantly undercapitalized corporate credit unions and undercapitalized corporate credit unions that fail to submit and implement capital restoration plans.

(i) In general. This paragraph applies with respect to any corporate credit union that--

(A) Is significantly undercapitalized; or

(B) Is undercapitalized and--

(1) Fails to submit an acceptable capital restoration plan within the time allowed by the NCUA under paragraph (e)(1) of this section; or

(2) Fails in any material respect to implement a plan accepted by the NCUA.

(ii) Specific actions authorized. The NCUA may take one or more of the following actions:

(A) Requiring recapitalization.

(1) Requiring the corporate credit union to seek and obtain additional contributed capital.

(2) Requiring the corporate credit union to increase its rate of earnings retention.

(3) Requiring the corporate credit union to combine, in whole or part, with another insured depository institution, if one or more grounds exist under this section or the Federal Credit Union Act for appointing a conservator or liquidating agent.

- (B) Restricting any ongoing or future transactions with affiliates.
- (C) Restricting interest rates paid.
  - (1) In general. Restricting the rates of dividends and interest that the corporate credit union pays on shares and deposits to the prevailing rates on shares and deposits of comparable amounts and maturities in the region where the institution is located, as determined by the NCUA.
  - (2) Retroactive restrictions prohibited. Paragraph (k)(3)(ii)(c) of this section does not authorize the NCUA to restrict interest rates paid on time deposits or shares made before (and not renewed or renegotiated after) the date the NCUA announced this restriction.
- (D) Restricting asset growth. Restricting the corporate credit union's asset growth more stringently than in paragraph (k)(2)(iii) of this section, or requiring the corporate credit union to reduce its total assets.
- (E) Restricting activities. Requiring the corporate credit union or any of its CUSOs to alter, reduce, or terminate any activity that the NCUA determines poses excessive risk to the corporate credit union.
- (F) Improving management. Doing one or more of the following:
  - (1) New election of directors. Ordering a new election for the corporate credit union's board of directors.
  - (2) Dismissing directors or senior executive officers. Requiring the corporate credit union to dismiss from office any director or senior executive officer who had held office for more than 180 days immediately before the corporate credit union became undercapitalized.
  - (3) Employing qualified senior executive officers. Requiring the corporate credit union to employ qualified senior executive officers (who, if the NCUA so specifies, will be subject to approval by the NCUA).
- (G) Requiring divestiture. Requiring the corporate credit union to divest itself of or liquidate any interest in any entity if the NCUA determines that the entity is in danger of becoming insolvent or otherwise poses a significant risk to the corporate credit union;
- (H) Conserve or liquidate the corporate credit union if NCUA determines the credit union has no reasonable prospect of becoming adequately capitalized; and
- (I) Requiring other action. Requiring the corporate credit union to take any other action that the NCUA determines will better carry out the purpose of this section than any of the actions described in this paragraph.
  - (iii) Senior executive officers' compensation restricted.
- (A) In general. The corporate credit union is prohibited from doing any of the following without the prior written approval of the NCUA:

- (1) Pay any bonus or profit-sharing to any senior executive officer.
- (2) Provide compensation to any senior executive officer at a rate exceeding that officer's average rate of compensation (excluding bonuses and profit-sharing) during the 12 calendar months preceding the calendar month in which the corporate credit union became undercapitalized.
  - (B) Failing to submit plan. The NCUA will not grant approval with respect to a corporate credit union that has failed to submit an acceptable capital restoration plan.
  - (iv) Discretion to impose certain additional restrictions. The NCUA may impose one or more of the restrictions prescribed by regulation under paragraph (k)(5) of this section if the NCUA determines that those restrictions are necessary to carry out the purpose of this section.
- (4) More stringent treatment based on other supervisory criteria.
  - (i) In general. If the NCUA determines, after notice and an opportunity for hearing as described in subpart M of part 747 of this chapter, that a corporate credit union is in an unsafe or unsound condition or deems the corporate credit union to be engaging in an unsafe or unsound practice, the NCUA may--
    - (A) If the corporate credit union is well capitalized, reclassify the corporate credit union as adequately capitalized;
    - (B) If the corporate credit union is adequately capitalized (but not well capitalized), require the corporate credit union to comply with one or more provisions of paragraphs (k)(1) and (k)(2) of this section, as if the corporate credit union were undercapitalized; or
    - (C) If the corporate credit union is undercapitalized, take any one or more actions authorized under paragraph (k)(3)(ii) of this section as if the corporate credit union were significantly undercapitalized.
  - (ii) Contents of plan. Any plan required under paragraph (k)(4)(i) of this section will specify the steps that the corporate credit union will take to correct the unsafe or unsound condition or practice. Capital restoration plans, however, will not be required under paragraph (k)(4)(i)(B) of this section.
- (5) Provisions applicable to critically undercapitalized corporate credit unions.
  - (i) Activities restricted. Any critically undercapitalized corporate credit union must comply with restrictions prescribed by the NCUA under paragraph (k)(6) of this section.
  - (ii) Payments on contributed capital and subordinated debt prohibited. A critically undercapitalized corporate credit union must not, beginning no later than 60 days after becoming critically undercapitalized, make any payment of

dividends on contributed capital or any payment of principal or interest on the corporate credit union's subordinated debt unless the NCUA determines that an exception would further the purpose of this section. Interest, although not payable, may continue to accrue under the terms of any subordinated debt to the extent otherwise permitted by law. Dividends on contributed capital do not, however, continue to accrue.

(iii) Conservatorship, liquidation, or other action. The NCUA may, at any time, conserve or liquidate any critically undercapitalized corporate credit union or require the credit union to combine, in whole or part, with another institution. NCUA will consider, not later than 90 days after a corporate credit union becomes critically undercapitalized, whether NCUA should liquidate, conserve, or combine the institution.

(6) Restricting activities of critically undercapitalized corporate credit unions. To carry out the purpose of this section, the NCUA will, by order--

(i) Restrict the activities of any critically undercapitalized corporate credit union; and

(ii) At a minimum, prohibit any such corporate credit union from doing any of the following without the NCUA's prior written approval:

(A) Entering into any material transaction other than in the usual course of business, including any investment, expansion, acquisition, sale of assets, or other similar action.

(B) Extending credit for any transaction NCUA determines to be highly leveraged.

(C) Amending the corporate credit union's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order.

(D) Making any material change in accounting methods.

(E) Paying compensation or bonuses NCUA determines to be excessive.

(F) Paying interest on new or renewed liabilities at a rate that would increase the corporate credit union's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest on insured deposits in the corporate credit union's normal market areas.

11. Revise §704.5 to read as follows:

§ 704.5. Investments.

(a) Policies. A corporate credit union must operate according to an investment policy that is consistent with its other risk management policies, including, but not limited to, those related to credit risk management, asset and liability management, and liquidity management. The policy must address, at a minimum:

(1) Appropriate tests and criteria for evaluating investments and investment transactions before purchase; and

(2) Reasonable and supportable concentration limits for limited liquidity investments in relation to capital.

(b) General. All investments must be U.S. dollar-denominated and subject to the credit policy restrictions set forth in § 704.6.

(c) Authorized activities. A corporate credit union may invest in:

(1) Securities, deposits, and obligations set forth in Sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act, 12 U.S.C. 1757(7), 1757(8), and 1757(15), except as provided in this section;

(2) Deposits in, the sale of federal funds to, and debt obligations of corporate credit unions, Section 107(8) institutions, and state banks, trust companies, and mutual savings banks not domiciled in the state in which the corporate credit union does business;

(3) Corporate CUSOs, as defined in and subject to the limitations of § 704.11;

(4) Marketable debt obligations of corporations chartered in the United States. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and

(5) Domestically-issued asset-backed securities.

(d) Repurchase agreements. A corporate credit union may enter into a repurchase agreement provided that:

(1) The corporate credit union, directly or through its agent, receives written confirmation of the transaction, and either takes physical possession or control of the repurchase securities or is recorded as owner of the repurchase securities through the Federal Reserve Book-Entry Securities Transfer System;

(2) The repurchase securities are legal investments for that corporate credit union;

(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of the repurchase securities and maintains adequate margin that reflects a risk assessment of the repurchase securities and the term of the transaction; and

(4) The corporate credit union has entered into signed contracts with all approved counterparties and agents, and ensures compliance with the contracts. Such contracts must address any supplemental terms and conditions necessary to meet the specific requirements of this part. Third party arrangements must be supported by tri-party contracts in which the repurchase securities are priced and reported daily and the tri-party agent ensures compliance; and

(e) Securities Lending. A corporate credit union may enter into a securities lending transaction provided that:

(1) The corporate credit union, directly or through its agent, receives written confirmation of the loan, obtains a first priority security interest in the collateral by taking physical possession or control of the collateral, or is recorded as owner of the collateral through the Federal Reserve Book-Entry Securities Transfer System;

(2) The collateral is a legal investment for that corporate credit union;

(3) The corporate credit union, directly or through its agent, receives daily assessment of the market value of collateral and maintains adequate margin that reflects a risk assessment of the collateral and terms of the loan; and

(4) The corporate credit union has entered into signed contracts with all agents and, directly or through its agent, has executed a written loan and security agreement with the borrower. The corporate or its agent ensures compliance with the agreements.

(f) Investment companies. A corporate credit union may invest in an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a), or a collective investment fund maintained by a national bank under 12 CFR 9.18 or a mutual savings bank under 12 CFR 550.260, provided that the company or fund prospectus restricts the investment portfolio to investments and investment transactions that are permissible for that corporate credit union.

(g) Investment settlement. A corporate credit union may only contract for the purchase or sale of an investment if the transaction is settled on a delivery versus payment basis within 60 days for mortgage-backed securities, within 30 days for new issues (other than mortgage-backed securities), and within three days for all other securities.

(h) Prohibitions. A corporate credit union is prohibited from:

- (1) Purchasing or selling derivatives, except for embedded options not required under GAAP to be accounted for separately from the host contract or forward sales commitments on loans to be purchased by the corporate credit union;
- (2) Engaging in trading securities unless accounted for on a trade date basis;
- (3) Engaging in adjusted trading or short sales;
- (4) Purchasing mortgage servicing rights, small business related securities, residual interests in collateralized mortgage obligations, residual interests in real estate mortgage investment conduits, or residual interests in asset-backed securities;
- (5) Purchasing net interest margin securities;
- (6) Purchasing collateralized debt obligations;
- (7) Purchasing private label residential mortgage-backed securities;
- (8) Purchasing subordinated securities; and

(9) Purchasing stripped mortgage-backed securities (SMBS), or securities that represent interests in SMBS, except as described in subparagraphs (i) and (iii) below.

(i) A corporate credit union may invest in exchangeable collateralized mortgage obligations (exchangeable CMOs) representing beneficial ownership interests in one or more interest-only classes of a CMO (IO CMOs) or principal-only classes of a CMO (PO CMOs), but only if:

(A) At the time of purchase, the ratio of the market price to the remaining principal balance is between .8 and 1.2, meaning that the discount or premium of the market price to par must be less than 20 points;

(B) The offering circular or other official information available at the time of purchase indicates that the notional principal on each underlying IO CMO should decline at the same rate as the principal on one or more of the underlying non-IO CMOs, and that the principal on each underlying PO CMO should decline at the same rate as the principal, or notional principal, on one or more of the underlying non-PO CMOs; and

(C) The credit union investment staff has the expertise dealing with exchangeable CMOs to apply the conditions in paragraphs (h)(5)(i)(A) and (B) of this section.

(ii) A corporate credit union that invests in an exchangeable CMO may exercise the exchange option only if all of the underlying CMOs are permissible investments for that credit union.

(iii) A corporate credit union may accept an exchangeable CMO representing beneficial ownership interests in one or more IO CMOs or PO CMOs as an asset associated with an investment repurchase transaction or as collateral in a securities lending transaction. When the exchangeable CMO is associated with one of these two transactions, it need not conform to the conditions in paragraphs (h)(5)(i)(A) or (B) of this section.

(i) Conflicts of interest. A corporate credit union's officials, employees, and immediate family members of such individuals, may not receive pecuniary consideration in connection with the making of an investment or deposit by the corporate credit union. Employee compensation is exempt from this prohibition. All transactions not specifically prohibited by this paragraph must be conducted at arm's length and in the interest of the corporate credit union.

(j) Grandfathering. A corporate credit union's authority to hold an investment is governed by the regulation in effect at the time of purchase. However, all grandfathered investments are subject to the requirements of §§704.8 and 704.9.

12. Revise §704.6 to read as follows:

§ 704.6. Credit risk management.

(a) Policies. A corporate credit union must operate according to a credit risk management policy that is commensurate with the investment risks and activities it undertakes. The policy must address at a minimum:

(1) The approval process associated with credit limits;

(2) Due diligence analysis requirements;

(3) Maximum credit limits with each obligor and transaction counterparty, set as a percentage of capital. In addition to addressing deposits and securities, limits with transaction counterparties must address aggregate exposures of all transactions including, but not limited to, repurchase agreements, securities lending, and forward settlement of purchases or sales of investments; and

(4) Concentrations of credit risk (e.g., originator of receivables, servicer of receivables, insurer, industry type, sector type, geographic, collateral type, and tranche priority).

(b) Exemption. The limitations and requirements of this section do not apply to certain assets, whether or not considered investments under this part, including fixed assets, individual loans and loan participation interests, investments in CUSOs, investments that are issued or fully guaranteed as to principal and interest by the U.S. government or its agencies or its sponsored enterprises (other than mortgage backed-securities), investments that are fully insured or guaranteed (including accumulated dividends and interest) by the NCUSIF or the Federal Deposit Insurance Corporation, and settlement funds in federally insured depository institutions.

(c) Issuer concentration limits— (1) General rule. The aggregate of all investments in any single obligor is limited to 25 percent of capital or \$5 million, whichever is greater.

(2) Exceptions.

(i) Investments in one obligor where the remaining maturity of all obligations is less than 30 days are limited to 50 percent of capital;

(ii) Investments in credit card master trust asset-backed securities are limited to 50 percent of capital in any single obligor;

(iii) Aggregate investments in repurchase and securities lending agreements with any one counterparty are limited to 200 percent of capital;

(iv) Investments in non-money market registered investment companies are limited to 50 percent of capital in any single obligor ;

(v) Investments in money market registered investment companies are limited to 100 percent of capital in any single obligor; and

(vi) Investments in corporate CUSOs are subject to the limitations of § 704.11.

(3) For purposes of measurement, each new credit transaction must be evaluated in terms of the corporate credit union's capital at the time of the transaction. An investment that fails a requirement of this section because of a subsequent reduction in capital will be deemed non-conforming. A corporate credit union is required to exercise reasonable efforts to bring nonconforming investments into conformity within 90 calendar days. Investments that remain nonconforming for 90 calendar days will be deemed to fail a requirement of this section and the corporate credit union will have to comply with § 704.10.

(d) Sector concentration limits. (1) A corporate credit union must establish sector limits that do not exceed the following maximums:

(i) Mortgage-backed securities (Inclusive of commercial mortgage-backed securities) – the lower of 1000 percent of capital or 50 percent of assets;

(ii) Commercial mortgage-backed securities – the lower of 300 percent of capital or 15 percent of assets;

(iii) FFELP student loan asset-backed securities – the lower of 1000 percent of capital or 50 percent of assets;

(iv) Private student loan asset-backed securities – the lower of 500 percent of capital or 25 percent of assets;

(v) Auto loan/lease asset-backed securities – the lower of 500 percent of capital or 25 percent of assets;

(vi) Credit card asset-backed securities – the lower of 500 percent of capital or 25 percent of assets;

(vii) Other asset-backed securities not listed in paragraphs (ii) through (vi) – the lower of 500 percent of capital or 25 percent of assets;

(viii) Corporate debt obligations – the lower of 1000 percent of capital or 50 percent of assets; and

(ix) Municipal securities – the lower of 1000 percent of capital or 50 percent of assets.

(2) Registered investment companies – A corporate credit union must limit its investment in registered investment companies to the lower of 1000 percent of capital or 50 percent of assets. In addition to applying the limit in this paragraph (d)(2), a corporate credit union must also include the underlying assets in each registered investment company in the relevant sectors described in paragraph (d)(1) of this section when calculating those sector limits.

(3) A corporate credit union will limit its aggregate holdings in any investments not described in paragraphs (d)(1) or (d)(2) to the lower of 100 percent of capital or 5 percent of assets. The NCUA may approve a higher percentage in appropriate cases.

(4) Investments in other federally insured credit unions, deposits and federal funds investments in other federally insured depository institutions, and investment repurchase agreements are excluded from the concentration limits in paragraphs (d)(1), (d)(2), and (d)(3) of this section.

(e) *Corporate debt obligation subsector limits.* In addition to the limitations in paragraph (d)(1)(viii) of this section, a corporate credit union must not exceed the lower of 200 percent of capital or 10 percent of assets in any single North American Industry Classification System (NAICS) industry sector. If the corporation does not have a readily ascertainable NAICS classification, a corporate credit union will use its reasonable judgment in assigning such a classification. NCUA may direct, however, that the corporate change the classification.

(f) *Credit ratings.* — (1) All investments, other than in another depository institution, must have an applicable credit rating from at least one NRSRO. At a minimum, 90 percent of all such investments, by book value, must have a rating by at least two NRSROs. Corporate credit unions may use either public or nonpublic NRSRO ratings to satisfy this requirement.

(2) At the time of purchase, investments with long-term ratings must be rated no lower than AA– (or equivalent) by every NRSRO that provides a publicly available long-term rating on that investment, and investments with short-term ratings must be rated no lower than A–1 (or equivalent) by every NRSRO that provides a publicly available short-term rating on that investment. If the corporate credit union obtains a nonpublic NRSRO rating, that rating must also be no lower than AA-, or A-1, for long-term and short-term ratings, respectively.

(3) All rating(s) relied upon to meet the requirements of this part must be identified at the time of purchase and must be monitored for as long as the corporate owns the investment. Corporate credit unions must identify and monitor any new post-purchase NRSRO ratings on investments they hold.

(4) Investments are subject to the requirements of §704.10 if:

(i) An NRSRO that rates the investment downgrades that rating, after purchase, below the minimum rating requirements of this part; or

(ii) The investment is part of an asset class or group of investments that exceeds the sector or obligor concentration limits of this section.

(g) *Reporting and documentation.* (1) At least annually, a written evaluation of each credit limit with each obligor or transaction counterparty must be prepared

and formally approved by the board or an appropriate committee. At least monthly, the board or an appropriate committee must receive an investment watch list of existing and/or potential credit problems and summary credit exposure reports, which demonstrate compliance with the corporate credit union's risk management policies.

(2) At a minimum, the corporate credit union must maintain:

(i) A justification for each approved credit limit;

(ii) Disclosure documents, if any, for all instruments held in portfolio. Documents for an instrument that has been sold must be retained until completion of the next NCUA examination; and

(iii) The latest available financial reports, industry analyses, internal and external analyst evaluations, and rating agency information sufficient to support each approved credit limit.

13. Revise § 704.8 to read as follows:

§ 704.8. Asset and liability management.

(a) Policies. A corporate credit union must operate according to a written asset and liability management policy which addresses, at a minimum:

(1) The purpose and objectives of the corporate credit union's asset and liability activities;

(2) The maximum allowable percentage decline in net economic value (NEV), compared to base case NEV;

(3) The minimum allowable NEV ratio;

(4) Policy limits and specific test parameters for the NEV sensitivity analysis requirements set forth in paragraphs (d), (e), and (f) of this section;

(5) The modeling of indexes that serve as references in financial instrument coupon formulas; and

(6) The tests that will be used, prior to purchase, to estimate the impact of investments on the percentage decline in NEV compared to base case NEV. The most recent NEV analysis, as determined under paragraph (d)(1)(i) of this section may be used as a basis of estimation.

(b) Asset and liability management committee (ALCO). A corporate credit union's ALCO must have at least one member who is also a member of the board of directors. The ALCO must review asset and liability management reports on at least a monthly basis. These reports must address compliance with Federal Credit Union Act, NCUA Rules and Regulations (12 CFR chapter VII), and all related risk management policies.

(c) Penalty for early withdrawals. A corporate credit union that permits early certificate/share withdrawals must assess market-based penalties sufficient to cover the estimated replacement cost of the certificate redeemed. This means the minimum penalty must be reasonably related to the rate that the corporate credit union would be required to offer to attract funds for a similar term with similar characteristics.

(d) Interest rate sensitivity analysis. (1) A corporate credit union must:

(i) Evaluate the risk in its balance sheet by measuring, at least quarterly, including once on the last day of the calendar quarter, the impact of an instantaneous, permanent, and parallel shock in the yield curve of plus and minus 100, 200, and 300 BP on its NEV and NEV ratio. If the base case NEV ratio falls below 3 percent at the last testing date, these tests must be calculated at least monthly, including once on the last day of the month, until the base case NEV ratio again exceeds 3 percent;

(ii) Limit its risk exposure to levels that do not result in a base case NEV ratio or any NEV ratio resulting from the tests set forth in paragraph (d)(1)(i) of this section below 2 percent; and

(iii) Limit its risk exposures to levels that do not result in a decline in NEV of more than 15 percent.

(2) A corporate credit union must assess annually if it should conduct periodic additional tests to address market factors that may materially impact that corporate credit union's NEV. These factors should include, but are not limited to, the following:

(i) Changes in the shape of the Treasury yield curve;

(ii) Adjustments to prepayment projections used for amortizing securities to consider the impact of significantly faster/slower prepayment speeds; and

(iii) Adjustments to volatility assumptions to consider the impact that changing volatilities have on embedded option values.

(e) Net interest income modeling. A corporate credit union must perform net interest income (NII) modeling to project earnings in multiple interest rate environments for a period of no less than 2 years. NII modeling must, at minimum, be performed at least quarterly, including once on the last day of the calendar quarter.

(f) Weighted average asset life. The weighted average life (WAL) of a corporate credit union's loan and investment portfolio, excluding derivative contracts and equity investments, may not exceed 2 years. A corporate credit union must test its assets at least quarterly, including once on the last day of the calendar quarter, for compliance with this WAL limitation. When calculating its WAL, a corporate credit union must assume that no issuer or market options will be exercised. If the WAL of a corporate credit union's assets exceeds 2 years on the testing date, this test must be calculated at least monthly, including once on the last day of the month, until the WAL is below 2 years.

(g) Weighted average asset life with 50 percent slowdown in prepayment speeds. The weighted average life (WAL) of a corporate credit union's loan and investment portfolio, excluding derivative contracts and equity investments, may not exceed 2.25 years when prepayment speeds are reduced by 50 percent. A corporate credit union must test its investments at least quarterly, including once on the last day of the calendar quarter, for compliance with this WAL limitation.

When calculating its WAL, a corporate credit union must assume that no issuer or market options will be exercised. If the WAL of a corporate credit union's assets exceeds 2.25 years, this test must be calculated at least monthly, including once on the last day of the month, until the WAL with the 50 slowdown in prepayment speeds is below 2.25 years.

(h) Government issued or guaranteed securities. The WAL of investments that are issued or fully guaranteed as to principal and interest by the U.S. government agencies or sponsored enterprises, including investments that are fully insured or guaranteed (including accumulated dividends and interest) by the NCUSIF or the Federal Deposit Insurance Corporation, will be multiplied by a factor of 0.50 for purposes of the WAL tests of paragraphs (f) and (g) of this section.

(i) Effective and spread durations. A corporate credit union must measure at least once a quarter, including once on the last day of the calendar quarter, the effective duration and spread durations of each of its assets and liabilities, where the values of these are affected by changes in interest rates or credit spreads.

(j) Regulatory violations. (1) (i) If a corporate credit union's decline in NEV, base case NEV ratio or any NEV ratio resulting from the test set forth in paragraph (d) of this section violates the limits established in that paragraph, or the corporate credit union is unable to satisfy the tests in paragraphs (f) or (g) of this section; and

(ii) The corporate cannot adjust its balance sheet so as to satisfy the requirements of paragraphs (d), (f), or (g) of this section within 10 calendar days after detecting the violation, then:

(iii) The operating management of the corporate credit union must immediately report this information to its board of directors, supervisory committee, and the NCUA.

(2) If any violation described in paragraph (j)(1)(i) persists for 30 or more calendar days, the corporate credit union:

(i) Must immediately submit a detailed, written action plan to the NCUA that sets forth the time needed and means by which it intends to correct the violation and, if the NCUA determines that the plan is unacceptable, the corporate credit union

must immediately restructure its balance sheet to bring the exposure back within compliance or adhere to an alternative course of action determined by the NCUA; and

(ii) If presently categorized as adequately capitalized or well capitalized for PCA purposes, immediately be recategorized as undercapitalized until the violation is corrected, and

(iii) If presently less than adequately capitalized, immediately be downgraded one additional capital category.

(k) Overall limit on business generated from individual credit unions. On or after [INSERT DATE 30 MONTHS AFTER DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER], a corporate credit union is prohibited from accepting from any member, or any nonmember credit union, any investment, including shares, loans, PCC, or NCAs if, following that investment, the aggregate of all investments from that entity in the corporate would exceed 15 percent of the corporate credit union's moving daily average net assets.

14. Revise § 704.9 to read as follows:

§ 704.9. Liquidity management.

(a) General. In the management of liquidity, a corporate credit union must:

(1) Evaluate the potential liquidity needs of its membership in a variety of economic scenarios;

(2) Regularly monitor and demonstrate accessibility to sources of internal and external liquidity;

(3) Keep a sufficient amount of cash and cash equivalents on hand to support its payment system obligations;

(4) Demonstrate that the accounting classification of investment securities is consistent with its ability to meet potential liquidity demands; and

(5) Develop a contingency funding plan that addresses alternative funding strategies in successively deteriorating liquidity scenarios. The plan must:

(i) List all sources of liquidity, by category and amount, that are available to service an immediate outflow of funds in various liquidity scenarios;

(ii) Analyze the impact that potential changes in fair value will have on the disposition of assets in a variety of interest rate scenarios; and

(iii) Be reviewed by the board or an appropriate committee no less frequently than annually or as market or business conditions dictate.

(b) Borrowing limits. A corporate credit union may borrow up to the lower of 10 times capital or 50 percent of capital and shares (excluding shares created by the use of member reverse repurchase agreements).

(1) Secured borrowings. A corporate credit union may borrow on a secured basis for liquidity purposes, but the maturity of the borrowing may not exceed 30 days. Only a credit union with core capital in excess of five percent of its moving DANA may borrow on a secured basis for nonliquidity purposes, and the outstanding amount of secured borrowing for nonliquidity purposes may not exceed an amount equal to the difference between core capital and five percent of moving DANA.

(2) Exclusions. CLF borrowings and borrowed funds created by the use of member reverse repurchase agreements are excluded from this limit.

15. Revise §704.11 to read as follows:

§ 704.11 Corporate Credit Union Service Organizations (Corporate CUSOs).

(a) A corporate CUSO is an entity that:

(1) Is at least partly owned by a corporate credit union;

(2) Primarily serves credit unions;

(3) Restricts its services to those related to the normal course of business of credit unions as specified in paragraph (e) of this section; and

(4) Is structured as a corporation, limited liability company, or limited partnership under state law.

(b) *Investment and loan limitations.* (1) The aggregate of all investments in member and non-member corporate CUSOs must not exceed 15 percent of a corporate credit union's capital.

(2) The aggregate of all investments in and loans to member and nonmember corporate CUSOs must not exceed 30 percent of a corporate credit union's capital. A corporate credit union may lend to member and nonmember corporate CUSOs an additional 15 percent of capital if the loan is collateralized by assets in which the corporate has a perfected security interest under state law.

(3) If the limitations in paragraphs (b)(1) and (b)(2) of this section are reached or exceeded because of the profitability of the CUSO and the related GAAP valuation of the investment under the equity method without an additional cash outlay by the corporate, divestiture is not required. A corporate credit union may continue to invest up to the regulatory limit without regard to the increase in the GAAP valuation resulting from the corporate CUSO's profitability.

(c) *Due diligence.* A corporate credit union must comply with the due diligence requirements of §§ 723.5 and 723.6(f) through (j) of this chapter for all loans to corporate CUSOs. This requirement does not apply to loans excluded under § 723.1(b).

(d) *Separate entity.* (1) A corporate CUSO must be operated as an entity separate from a corporate credit union.

(2) A corporate credit union investing in or lending to a corporate CUSO must obtain a written legal opinion that concludes the corporate CUSO is organized and operated in a manner that the corporate credit union will not reasonably be held liable for the obligations of the corporate CUSO. This opinion must address factors that have led courts to "pierce the corporate veil," such as inadequate capitalization, lack of corporate identity, common boards of directors and employees, control of one entity over another, and lack of separate books and records.

(e). *Permissible activities.* (1) Beginning on [INSERT DATE 180 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], a corporate CUSO must agree to limit its activities to:

(i) Brokerage services,

(ii) Investment advisory services, and

(iii) Other categories of activities as approved in writing by NCUA and published on NCUA's website.

(2) A corporate credit union must divest from any CUSO that is engaged in activities not approved by NCUA under paragraph (e)(1) of this section. A corporate credit union may take until [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] to divest itself from a CUSO engaging in one or more unapproved activities, but only if the CUSO was engaging in those activities before [INSERT DATE OF PUBLICATION IN FEDERAL REGISTER] and the corporate credit union can establish that those activities satisfied the requirements of this section as it existed before [INSERT DATE OF PUBLICATION IN FEDERAL REGISTER].

(3) Once NCUA has approved an activity and published that activity on its website as provided for in paragraph (e)(1)(iii) of this section, NCUA will not remove that particular activity the approved list, or make substantial changes to the content or description of that approved activity, except through the formal rulemaking process.

(f) An official of a corporate credit union which has invested in or loaned to a corporate CUSO may not receive, either directly or indirectly, any salary, commission, investment income, or other income, compensation, or consideration from the corporate CUSO. This prohibition also extends to immediate family members of officials.

(g) Prior to making an investment in or loan to a corporate CUSO, a corporate credit union must obtain a written agreement that the CUSO:

(1) Will follow GAAP;

(2) Will provide financial statements to the corporate credit union at least quarterly;

(3) Will obtain an annual CPA opinion audit and provide a copy to the corporate credit union. A wholly owned or majority owned CUSO is not required to obtain a separate annual audit if it is included in the corporate credit union's annual consolidated audit;

(4) Will not acquire control, directly or indirectly, of another depository financial institution or to invest in shares, stocks, or obligations of an insurance company, trade association, liquidity facility, or similar organization;

(5) Will allow the auditor, board of directors, and NCUA complete access to its personnel, facilities, equipment, books, records, and any other documentation that the auditor, directors, or NCUA deem pertinent; and

(6) Will comply with all the requirements of this section.

(h) Corporate credit union authority to invest in or loan to a CUSO is limited to that provided in this section. A corporate credit union is not authorized to invest in or loan to a CUSO under part 712 of this chapter.

16. Revise paragraph (a) of §704.14 to read as follows:

§ 704.14. Representation.

(a) Board representation. The board will be determined as stipulated in its bylaws governing election procedures, provided that:

(1) At least a majority of directors, including the chair of the board, must serve on the board as representatives of member credit unions;

(2) On or after [INSERT DATE 120 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], only individuals who currently hold the position of chief executive officer, chief financial officer, chief operating officer, or treasurer/manager at a member may seek election or re-election to the board;

(3) No individual may be elected or appointed to serve on the board if, after such election or appointment, the individual would be a director at more than one corporate credit union;

(4) No individual may be elected or appointed to serve on the board if, after such election or appointment, any member of the corporate credit union would have more than one representative on the board of the corporate;

(5) The chair of the board may not serve simultaneously as an officer, director, or employee of a credit union trade association;

(6) A majority of directors may not serve simultaneously as officers, directors, or employees of the same credit union trade association or its affiliates (not including chapters or other subunits of a state trade association);

(7) For purposes of meeting the requirements of paragraphs (a)(5) and (a)(6) of this section, an individual may not serve as a director or chair of the board if that individual holds a subordinate employment relationship to another employee who serves as an officer, director, or employee of a credit union trade association;

(8) In the case of a corporate credit union whose membership is composed of more than 25 percent non credit unions, the majority of directors serving as representatives of member credit unions, including the chair, must be elected only by member credit unions, and

(9) After [INSERT DATE 36 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], at least a majority of directors of every corporate credit union, including the chair of the board, must serve on the board as representatives of natural person credit union members.

\* \* \* \* \*

17. Revise §704.19 to read as follows:

§704.19 Disclosure of executive and director compensation.

(a) Annual disclosure. Corporate credit unions must annually prepare and maintain a disclosure of the compensation, in dollar terms, paid to its most highly compensated employees, in accordance with the following schedule:

- (1) For corporate credit unions with forty-one or more full time employees, disclosure is required of the compensation paid to the five most highly compensated employees;
- (2) For corporate credit unions with between thirty and forty-one full time employees, disclosure is required of the compensation paid to the four most highly compensated employees;
- (3) For corporate credit unions with thirty or fewer full time employees, disclosure is required of the compensation paid to the three most highly compensated employees; and
- (4) In all cases, compensation paid to the corporate credit union's chief executive officer must also be disclosed, if the chief executive officer is not already included among the most highly compensated employees described in subparagraphs (a)(1) through (a)(3) of this section.

(b) Availability of disclosure. Any member may obtain a copy of the most current disclosure, and all disclosures for the previous three years, on request made in person or in writing. The corporate credit union must provide the disclosure(s), at no cost to the member, within five business days of receiving the request. In addition, the corporate must distribute the most current disclosure to all its members at least once a year, either in the annual report or in some other manner of the corporate's choosing.

(c) Supplemental information. In providing the disclosure required by this section, a corporate credit union may also provide supplementary information to put the disclosure in context, for example, salary surveys, a discussion of compensation in relation to other credit union expenses, or compensation information from similarly sized credit unions or financial institutions.

(d) Special rule for mergers. With respect to any merger involving a corporate credit union that would result in a material increase in compensation, i.e., an increase of more than 15 percent or \$10,000, whichever is greater, for any senior executive officer or director of the merging corporate, the corporate must: (i) describe the compensation arrangement in the merger plan documents submitted to NCUA for approval of the merger, pursuant to §708b of this part; and (ii) in the case of any federally chartered corporate credit union, describe the compensation arrangement in the materials provided to the membership of the merging credit union before the member vote on approving the merger.

18. Add a new §704.20 to read as follows:

§ 704.20. Limitations on golden parachute and indemnification payments.

(a) Definitions. The following definitions apply for this section:

(1) Board means the National Credit Union Administration Board.

(2) Benefit plan means any plan, contract, agreement or other arrangement which is an "employee welfare benefit plan" as that term is defined in section 3(1) of the Employee Retirement Income Security Act of 1974, as amended (29 U.S.C. 1002(1)), or other usual and customary plans such as dependent care, tuition reimbursement, group legal services or cafeteria plans; provided however, that such term does not include any plan intended to be subject to paragraphs (a)(4)(iv)(C) and (E) of this section.

(3) Bona fide deferred compensation plan or arrangement means any plan, contract, agreement or other arrangement whereby:

(i) An institution-affiliated party (IAP) voluntarily elects to defer all or a portion of the reasonable compensation, wages or fees paid for services rendered which otherwise would have been paid to the IAP at the time the services were rendered (including a plan that provides for the crediting of a reasonable investment return on such elective deferrals) and the corporate credit union either:

(A) Recognizes compensation expense and accrues a liability for the benefit payments according to Generally Accepted Accounting Principles (GAAP); or

(B) Segregates or otherwise sets aside assets in a trust which may only be used to pay plan and other benefits, except that the assets of such trust may be available to satisfy claims of the institution's or holding company's creditors in the case of insolvency; or

(ii) A corporate credit union establishes a nonqualified deferred compensation or supplemental retirement plan, other than an elective deferral plan described in paragraph (a)(3)(i) of this section:

(A) Primarily for the purpose of providing benefits for certain IAPs in excess of the limitations on contributions and benefits imposed by Sections 415, 401(a)(17), 402(g) or any other applicable provision of the Internal Revenue Code of 1986 (26 USC 415, 401(a)(17), 402(g)); or

(B) Primarily for the purpose of providing supplemental retirement benefits or other deferred compensation for a select group of directors, management or highly compensated employees (excluding severance payments described in paragraph (4)(ii)(E) of this section and permissible golden parachute payments described in §704.20(d); and

(iii) In the case of any nonqualified deferred compensation or supplemental retirement plans as described in paragraphs (a)(3)(i) and (ii) of this section, the following requirements will apply:

(A) The plan was in effect at least one year prior to any of the events described in paragraph (a)(4)(ii) of this section;

(B) Any payment made pursuant to such plan is made in accordance with the terms of the plan as in effect no later than one year prior to any of the events described in paragraph (a)(4)(ii) of this section and in accordance with any amendments to such plan during such one year period that do not increase the benefits payable thereunder;

(C) The IAP has a vested right, as defined under the applicable plan document, at the time of termination of employment to payments under such plan;

(D) Benefits under such plan are accrued each period only for current or prior service rendered to the employer (except that an allowance may be made for service with a predecessor employer);

(E) Any payment made pursuant to such plan is not based on any discretionary acceleration of vesting or accrual of benefits which occurs at any time later than one year prior to any of the events described in paragraph (a)(4)(ii) of this section;

(F) The corporate credit union has previously recognized compensation expense and accrued a liability for the benefit payments according to GAAP or segregated or otherwise set aside assets in a trust which may only be used to pay plan benefits, except that the assets of such trust may be available to satisfy claims of the corporate credit union's creditors in the case of insolvency; and

(G) Payments pursuant to such plans must not be in excess of the accrued liability computed in accordance with GAAP.

(4) Golden parachute payment means any payment (or any agreement to make any payment) in the nature of compensation by any corporate credit union for the benefit of any current or former IAP pursuant to an obligation of such corporate credit union that:

(i) Is contingent on, or by its terms is payable on or after, the termination of such IAP's primary employment or affiliation with the corporate credit union; and

(ii) Is received on or after, or is made in contemplation of, any of the following events:

(A) The insolvency (or similar event) of the corporate that is making the payment; or

(B) The appointment of any conservator or liquidating agent for such corporate credit union; or

(C) A determination by the Board or the appropriate state supervisory authority (in the case of a state-chartered corporate credit union) respectively, that the corporate credit union is in a troubled condition; or

(D) The corporate credit union is undercapitalized, as defined in §704.4; or

(E) The corporate credit union is subject to a proceeding to terminate or suspend its share account insurance; and

(iii) Is payable to an IAP whose employment by or affiliation with the corporate is terminated at a time when the corporate credit union by which the IAP is employed or with which the IAP is affiliated satisfies any of the conditions enumerated in paragraphs (a)(4)(ii)(A) through (E) of this section, or in contemplation of any of these conditions.

(iv) Exceptions. The term *golden parachute payment* does not include:

(A) Any payment made pursuant to a pension or retirement plan which is qualified (or is intended within a reasonable period of time to be qualified) under Section 401 of the Internal Revenue Code of 1986 (26 USC §401); or

(B) Any payment made pursuant to a benefit plan as that term is defined in paragraph (a)(2) of this section; or

(C) Any payment made pursuant to a *bona fide* deferred compensation plan or arrangement as defined in paragraph (a)(3) of this section; or

(D) Any payment made by reason of death or by reason of termination caused by the disability of an IAP; or

(E) Any payment made pursuant to a nondiscriminatory severance pay plan or arrangement which provides for payment of severance benefits to all eligible employees upon involuntary termination other than for cause, voluntary resignation, or early retirement; *provided, however*, that no employee will receive any such payment which exceeds the base compensation paid to such employee during the twelve months (or such longer period or greater benefit as the Board will consent to) immediately preceding termination of employment, resignation or early retirement, and such severance pay plan or arrangement must not have been adopted or modified to increase the amount or scope of severance benefits at a time when the corporate credit union was in a condition specified in paragraph (4)(ii) of this section or in contemplation of such a condition without the prior written consent of the Board; or

(F) Any severance or similar payment which is required to be made pursuant to a state statute which is applicable to all employers within the appropriate jurisdiction (with the exception of employers that may be exempt due to their small number of employees or other similar criteria); or

(G) Any other payment which the Board determines to be permissible in accordance with §704.20(d).

(5) Institution-affiliated party (IAP) means any individual meeting the criteria specified in §206(r) of the Act (12 USC §1786(r)).

(6) Liability or legal expense means:

(i) Any legal or other professional fees and expenses incurred in connection with any claim, proceeding, or action;

(ii) The amount of, and any cost incurred in connection with, any settlement of any claim, proceeding, or action; and

(iii) The amount of, and any cost incurred in connection with, any judgment or penalty imposed with respect to any claim, proceeding, or action.

(7) Nondiscriminatory means that the plan, contract or arrangement in question applies to all employees of a corporate credit union who meet reasonable and customary eligibility requirements applicable to all employees, such as minimum length of service requirements. A nondiscriminatory plan, contract or arrangement may provide different benefits based only on objective criteria such as salary, total compensation, length of service, job grade or classification, which are applied on a proportionate basis (with a variance in severance benefits relating to any criterion of plus or minus ten percent) to groups of employees consisting of not less than the lesser of 33 percent of employees or 1,000 employees.

(8) Payment means:

(i) Any direct or indirect transfer of any funds or any asset;

(ii) Any forgiveness of any debt or other obligation;

(iii) The conferring of any benefit, including but not limited to stock options and stock appreciation rights; or

(iv) Any segregation of any funds or assets, the establishment or funding of any trust or the purchase of or arrangement for any letter of credit or other instrument, for the purpose of making, or pursuant to any agreement to make, any payment on or after the date on which such funds or assets are segregated, or at the time of or after such trust is established or letter of credit or other instrument is made available, without regard to whether the obligation to make such payment is contingent on:

(A) The determination, after such date, of the liability for the payment of such amount; or

(B) The liquidation, after such date, of the amount of such payment.

(9) Prohibited indemnification payment means any payment (or any agreement or arrangement to make any payment) by any corporate credit union for the benefit of any person who is or was an IAP of such corporate credit union, to pay or reimburse such person for any civil money penalty, judgment or other liability or legal expense resulting from any administrative or civil action instituted by the Board or any appropriate state regulatory authority that results in a final order or settlement pursuant to which such person:

(i) Is assessed a civil money penalty;

(ii) Is removed from office or prohibited from participating in the conduct of the affairs of the corporate credit union; or

(iii) Is required to cease and desist from or take any affirmative action described in Section 206 of the Act with respect to such corporate credit union.

(iv) *Exceptions.* The term *prohibited indemnification payment* does not include any reasonable payment by a corporate credit union that:

(A) is used to purchase any commercial insurance policy or fidelity bond, provided that such insurance policy or bond must not be used to pay or reimburse an IAP for the cost of any judgment or civil money penalty assessed against such person in an administrative proceeding or civil action commenced by NCUA or the appropriate state supervisory authority (in the case of a state chartered corporate), but may pay any legal or professional expenses incurred in connection with such proceeding or action or the amount of any restitution to the corporate credit union or its liquidating agent; or

(B) represents partial indemnification for legal or professional expenses specifically attributable to particular charges for which there has been a formal and final adjudication or finding in connection with a settlement that the IAP has not violated certain laws or regulations or has not engaged in certain unsafe or unsound practices or breaches of fiduciary duty, unless the administrative action or civil proceeding has resulted in a final prohibition order against the IAP.

(10) Troubled Condition means that the corporate credit union:

(i) Has been assigned:

(A) a 4 or 5 Corporate Risk Information System (CRIS) rating by NCUA in either the Financial Risk or Risk Management composites, in the case of a federal corporate credit union, or

(B) an equivalent 4 or 5 CRIS rating in either the Financial Risk or Risk Management composites by the state supervisory authority (SSA) in the case of a federally insured, state-chartered corporate credit union in a state that has adopted the CRIS system, or an equivalent 4 or 5 CAMEL composite rating by the SSA in the case of a federally insured, state-chartered corporate credit union in a state that uses the CAMEL system, or

(C) a 4 or 5 CRIS rating in either the Financial Risk or Risk Management composites by NCUA based on core work papers received from the SSA in the case of a federally insured, state-chartered credit union in a state that does not use either the CRIS or CAMEL system. In this case, the SSA will be notified in writing by the Director of the Office of Corporate Credit Unions that the corporate credit union has been designated by NCUA as a troubled institution; or

(ii) has been granted assistance as outlined under Sections 208 or 216 of the Federal Credit Union Act.

(b) Golden parachute payments prohibited.

No corporate credit union will make or agree to make any golden parachute payment, except as otherwise provided in this section.

(c) Prohibited indemnification payments. No corporate credit union will make or agree to make any prohibited indemnification payment, except as provided in this section.

(d) Permissible golden parachute payments. (1) A corporate credit union may agree to make or may make a golden parachute payment if and to the extent that:

(i) Such an agreement is made in order to hire a person to become an IAP either at a time when the corporate credit union satisfies or in an effort to prevent it from imminently satisfying any of the criteria set forth in §(a)(4)(ii), and the Board, consents in writing to the amount and terms of the golden parachute payment. Such consent by the Board must not improve the IAP's position in the event of the insolvency of the corporate credit union since such consent can neither bind a liquidating agent nor affect the provability of claims in liquidation. In the event that the institution is placed into conservatorship or liquidation, the conservator or the liquidating agent, as the case may be, will not be obligated to pay the promised golden parachute and the IAP will not be accorded preferential treatment on the basis of such prior approval; or

(ii) Such a payment is made pursuant to an agreement which provides for a reasonable severance payment, not to exceed twelve months salary, to an IAP in the event of a merger with another corporate credit union; *provided, however,* that a corporate credit union must obtain the consent of the Board, before making such a payment and this paragraph (d)(1)(iii) does not apply to any merger between corporates that results from an assisted transaction as described in Section 208 of the Act (12 U.S.C. 1788) or the corporate credit union being placed into conservatorship or liquidation; or

(iii) The Board, with the written concurrence of the appropriate state supervisory authority (in the case of a state-chartered corporate), determines that such a payment or agreement is permissible.

(2) A corporate credit union making a request pursuant to paragraphs (d)(1)(i) through (iii) of this section must demonstrate that it does not possess and is not aware of any information, evidence, documents or other materials which would indicate that there is a reasonable basis to believe, at the time such payment is proposed to be made, that:

(i) The IAP has committed any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the corporate credit union that has had or is likely to have a material adverse effect on the corporate credit union;

(ii) The IAP is substantially responsible for the insolvency of, the appointment of a conservator or liquidating agent for, or the troubled condition, as defined by §701.14(b)(4), of the corporate credit union;

(iii) The IAP has materially violated any applicable federal or state banking law or regulation that has had or is likely to have a material effect on the corporate credit union; and

(iv) The IAP has violated or conspired to violate Section 215, 656, 657, 1005, 1006, 1007, 1014, 1032, or 1344 of Title 18 of the United States Code, or Section 1341 or 1343 of such title affecting a federally insured financial institution as defined in Title 18 of the United States Code.

(3) In making a determination under paragraphs (d)(1)(i) through (iii) of this section, the Board may consider:

(i) Whether, and to what degree, the IAP was in a position of managerial or fiduciary responsibility;

(ii) The length of time the IAP was affiliated with the corporate credit union, and the degree to which the proposed payment represents a reasonable payment for services rendered over the period of employment; and

(iii) Any other factors or circumstances which would indicate that the proposed payment would be contrary to the intent of Section 206(t) of the Act or this part.

(e) Permissible indemnification payments. (1) A corporate credit union may make or agree to make reasonable indemnification payments to an IAP with respect to an administrative proceeding or civil action initiated by NCUA or a state regulatory authority if:

(i) The corporate credit union's board of directors, in good faith, determines in writing after due investigation and consideration that the institution-affiliated party acted in good faith and in a manner he/she believed to be in the best interests of the membership;

(ii) The corporate credit union's board of directors, in good faith, determines in writing after due investigation and consideration that the payment of such expenses will not materially adversely affect the institution's or holding company's safety and soundness;

(iii) The indemnification payments do not constitute prohibited indemnification payments as that term is defined in §704.20(c); and

(iv) The IAP agrees in writing to reimburse the corporate credit union, to the extent not covered by payments from insurance or bonds purchased pursuant to §704.20(a)(9)(iv)(A), for that portion of the advanced indemnification payments which subsequently become prohibited indemnification payments, as defined in §704.20(a)(9).

(2) An IAP seeking indemnification payments must not participate in any way in the board's discussion and approval of such payments; *provided, however*, that such IAP may present his/her request to the board and respond to any inquiries from the board concerning his/her involvement in the circumstances giving rise to the administrative proceeding or civil action.

(3) In the event that a majority of the members of the board of directors are named as respondents in an administrative proceeding or civil action and request indemnification, the remaining members of the board may authorize independent legal counsel to review the indemnification request and provide the remaining members of the board with a written opinion of counsel as to whether the

conditions delineated in paragraph (e)(1) of this section have been met. If independent legal counsel opines that said conditions have been met, the remaining members of the board of directors may rely on such opinion in authorizing the requested indemnification.

(4) In the event that all of the members of the board of directors are named as respondents in an administrative proceeding or civil action and request indemnification, the board will authorize independent legal counsel to review the indemnification request and provide the board with a written opinion of counsel as to whether the conditions delineated in paragraph (e)(1) of this section have been met. If independent legal counsel opines that said conditions have been met, the board of directors may rely on such opinion in authorizing the requested indemnification.

(f) *Filing instructions.* Requests to make excess nondiscriminatory severance plan payments pursuant to §704.20(a)(4)(iv)(E) and golden parachute payments permitted by §704.20(d) must be submitted in writing to the Board. The request must be in letter form and must contain all relevant factual information as well as the reasons why such approval should be granted.

(g) *Applicability in the event of liquidation or conservatorship.* The provisions of this part, or any consent or approval granted under the provisions of this part by the Board, will not in any way bind any liquidating agent or conservator for a failed corporate credit union and will not in any way obligate the liquidating agent or conservator to pay any claim or obligation pursuant to any golden parachute, severance, indemnification or other agreement. Claims for employee welfare benefits or other benefits that are contingent, even if otherwise vested, when a liquidating agent or conservator is appointed for any corporate credit union, including any contingency for termination of employment, are not provable claims or actual, direct compensatory damage claims against such liquidating agent or conservator. Nothing in this part may be construed to permit the payment of salary or any liability or legal expense of any IAP contrary to 12 U.S.C. 1786(t)(3).

19. Revise Appendix A to part 704 to read as follows:

APPENDIX A TO PART 704 – Capital Prioritization and Model Forms  
Part I – Optional Capital Prioritization

Notwithstanding any other provision in this chapter, a corporate credit union, at its option, may determine that capital contributed to the corporate on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] will have priority, for purposes of availability to absorb losses and payout in liquidation, over capital contributed to the corporate before that date. The board of directors at a corporate credit union that desires to make this determination must:

- a) On or before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], adopt a resolution implementing its determination.
- b) Inform the credit union's members and NCUA, in writing and as soon as practicable after adoption of the resolution, of the contents of the board resolution.
- c) Ensure the credit union uses the appropriate initial and periodic Model Form disclosures in Part II below.

## Part II – Model Forms

Part II contains model forms intended for use by corporate credit unions to aid in compliance with the capital disclosure requirements of § 704.3 and Part I of this Appendix.

### MODEL FORM A

#### Terms and Conditions of Membership Capital Account

[NOTE: This form is for use before [INSERT DATE 12 MONTHS AFTER DATE PUBLICATION IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined NOT to give newly issued capital priority over older capital as described in Part I of this Appendix]

- (1) A membership capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.
- (2) A membership capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the membership capital account transfers to the continuing credit union. In the event of a charter conversion, the membership capital account transfers to the new institution. In the event of liquidation, the membership capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.
- (3) A member credit union may withdraw membership capital with three

years' notice.

(4) Membership capital cannot be used to pledge borrowings.

(5) Membership capital is available to cover losses that exceed retained earnings and paid-in capital.

(6) Where the corporate credit union is liquidated, membership capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF.

(7) Where the corporate credit union is merged into another corporate credit union, the membership capital account will transfer to the continuing corporate credit union. The three-year notice period for withdrawal of the membership capital account will remain in effect.

(8) If an adjusted balance account--: The membership capital balance will be adjusted--(1 or 2)--- time(s) annually in relation to the member credit union's--- (assets or other measure)--- as of---(date(s))---. If a term certificate--: The membership capital account is a term certificate that will mature on---(date)---.

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the membership capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with membership capital accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

## MODEL FORM B

### Terms and Conditions of Membership Capital Account

[NOTE: This form is for use before [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined THAT IT WILL give newly issued capital priority over older capital as described in Part I of this Appendix].

(1) A membership capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A membership capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the membership capital account transfers to the continuing credit union. In the event of a charter conversion, the membership capital account transfers to the new institution. In the event of liquidation, the membership capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) A member credit union may withdraw membership capital with three years' notice.

(4) Membership capital cannot be used to pledge borrowings.

(5) (a) Membership capital that is issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], is available to cover losses that exceed retained earnings, contributed capital issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], and perpetual capital issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Any such losses will be distributed *pro rata*, at the time the loss is realized, among membership capital account holders with accounts issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. To the extent that NCA funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(b) Membership capital that is issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] is available to cover losses that exceed retained earnings and perpetual capital issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Any such losses will be distributed *pro rata*, at the time the loss is realized, among membership capital account holders with accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. To the extent that NCA funds are used to cover losses,

the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(c) Attached to this disclosure is a statement that describes the amount of NCA the credit union has with the corporate credit union in each of the categories described in paragraphs (5)(a) and (5)(b) above.

(6) If the corporate credit union is liquidated:

(a) Membership capital accounts issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including contributed capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] and perpetual capital accounts issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. However, membership capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

(b) Membership capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including perpetual capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. However, membership capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

(7) Where the corporate credit union is merged into another corporate credit union, the membership capital account will transfer to the continuing corporate credit union. The three-year notice period for withdrawal of the membership capital account will remain in effect.

(8) If an adjusted balance account--: The membership capital balance will be adjusted--(1 or 2)--- time(s) annually in relation to the member credit union's--- (assets or other measure)--- as of---(date(s))---. If a term certificate--: The membership capital account is a term certificate that will mature on---(date)---

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the membership capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with membership capital accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

## MODEL FORM C

### Terms and Conditions of Nonperpetual Capital

[NOTE: This form is for use on and after [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined NOT to give newly issued capital priority over older capital as described in Part I of this Appendix. Also, corporate credit unions should ensure that existing membership capital accounts that do not meet the qualifying conditions for nonperpetual capital are modified so as to meet those conditions.]

### Terms and Conditions of Nonperpetual Capital Account

(1) A nonperpetual capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A nonperpetual capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the nonperpetual capital account transfers to the continuing credit union. In the event of a charter conversion, the nonperpetual capital account transfers to the new institution. In the event of liquidation, the nonperpetual capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) If the nonperpetual capital account is a notice account, a member credit

union may withdraw the nonperpetual capital with a minimum of five years' notice. If the nonperpetual capital account is a term instrument it may be redeemed only at maturity. The corporate credit union may not redeem any account prior to the expiration of the notice period, or maturity, without the prior written approval of the NCUA.

(4) Nonperpetual capital cannot be used to pledge borrowings.

(5) Nonperpetual capital is available to cover losses that exceed retained earnings and perpetual contributed capital. Any such losses will be distributed *pro rata* among nonperpetual capital account holders at the time the loss is realized. To the extent that NCA funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(6) Where the corporate credit union is liquidated, nonperpetual capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF. However, nonperpetual capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

(7) Where the corporate credit union is merged into another corporate credit union, the nonperpetual capital account will transfer to the continuing corporate credit union. For notice accounts, the five-year notice period for withdrawal of the nonperpetual capital account will remain in effect. For term accounts, the original term will remain in effect.

(8) If a term certificate--: The nonperpetual capital account is a term certificate that will mature on---(date)--- (insert date with a minimum five-year original maturity).

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the nonperpetual capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with nonperpetual capital accounts. The

certification must be maintained in the corporate credit union's files and be available for examiner review.

## MODEL FORM D

### Terms and Conditions of Nonperpetual capital

[NOTE: This form is for use before [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined THAT IT WILL give newly issued capital priority over older capital as described in Part I of this Appendix. Also, corporate credit unions should ensure that existing membership capital accounts that do not meet the qualifying conditions for nonperpetual capital are modified so as to meet those conditions.]

### Terms and Conditions of Nonperpetual Capital Account

(1) A nonperpetual capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A nonperpetual capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the nonperpetual capital account transfers to the continuing credit union. In the event of a charter conversion, the nonperpetual capital account transfers to the new institution. In the event of liquidation, the nonperpetual capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) If the nonperpetual capital account is a notice account, a member credit union may withdraw the nonperpetual capital with a minimum of five years' notice. If the nonperpetual capital account is a term instrument it may be redeemed only at maturity. The corporate credit union may not redeem any account prior to the expiration of the notice period, or maturity, without the prior written approval of the NCUA.

(4) Nonperpetual capital cannot be used to pledge borrowings.

(5)(a) Nonperpetual capital that is issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] is available to

cover losses that exceed retained earnings, all contributed capital issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], and perpetual capital issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Any such losses will be distributed *pro rata*, at the time the loss is realized, among nonperpetual capital account holders with accounts issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. To the extent that NCA funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(b) Nonperpetual capital that is issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], is available to cover losses that exceed retained earnings and perpetual capital issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Any such losses will be distributed *pro rata*, at the time the loss is realized, among nonperpetual capital account holders with accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. To the extent that NCA funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(c) Attached to this disclosure is a statement that describes the amount of NCA the credit union has with the corporate credit union in each of the categories described in paragraphs (5)(a) and (5)(b) above.

(6) If the corporate credit union is liquidated:

(a) Nonperpetual capital accounts issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including contributed capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] or perpetual capital accounts issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. However, nonperpetual capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

(b) Nonperpetual capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including perpetual capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. However, nonperpetual capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

(7) Where the corporate credit union is merged into another corporate credit union, the nonperpetual capital account will transfer to the continuing corporate credit union. For notice accounts, the five-year notice period for withdrawal of the nonperpetual capital account will remain in effect. For term accounts, the original term will remain in effect.

(8) If a term certificate--: The nonperpetual capital account is a term certificate that will mature on---(date)--- (insert date with a minimum five-year original maturity).

I have read the above terms and conditions and I understand them.

I further agree to maintain in the credit union's files the annual notice of terms and conditions of the nonperpetual capital account.

The notice form must be signed by either all of the directors of the member credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

The annual disclosure notice form must be signed by the chair of the corporate credit union. The chair must then sign a statement that certifies that the notice has been sent to member credit unions with nonperpetual capital accounts. The certification must be maintained in the corporate credit union's files and be available for examiner review.

## MODEL FORM E

### Terms and Conditions of Paid-in Capital

[NOTE: This form is for use before [INSERT DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined NOT to give newly issued capital priority over older capital as described in Part I of this Appendix]

#### Terms and Conditions of Paid-In Capital

(1) A paid-in capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A paid-in capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the paid-in capital account transfers to the continuing credit union. In the event of a charter conversion, the paid-in capital account transfers to the new institution. In the event of liquidation, the paid-in capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called. The corporate must also obtain NCUA's approval before the corporate calls any paid-in capital.

(4) Paid-in capital cannot be used to pledge borrowings.

(5) Paid-in capital is available to cover losses that exceed retained earnings.

(6) Where the corporate credit union is liquidated, paid-in capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, and membership capital holders.

(7) Where the corporate credit union is merged into another corporate credit union, the paid-in capital account will transfer to the continuing corporate credit union.

(8) Paid-in capital is perpetual maturity and noncumulative dividend.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the paid-in capital instrument.

The notice form must be signed by either all of the directors of the credit union or,

if authorized by board resolution, the chair and secretary of the board of the credit union.

## MODEL FORM F

### Terms and Conditions of Paid-in Capital

[NOTE: This form is for use before [INSERT DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined THAT IT WILL give newly issued capital priority over older capital as described in Part I of this Appendix].

### Terms and Conditions of Paid-In Capital

(1) A paid-in capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A paid-in capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the paid-in capital account transfers to the continuing credit union. In the event of a charter conversion, the paid-in capital account transfers to the new institution. In the event of liquidation, the paid-in capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called. The corporate must also obtain NCUA's approval before the corporate calls any paid-in capital.

(4) Paid-in capital cannot be used to pledge borrowings.

(5) Availability to cover losses.

(a) Paid-in capital issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] is available to cover losses that exceed retained earnings. Any such losses must be distributed *pro rata*, at the time the loss is realized, among holders of paid-in capital issued before [INSERT

DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. To the extent that paid-in capital funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(b) Paid-in capital issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] is available to cover losses that exceed retained earnings and any contributed capital issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Any such losses must be distributed *pro rata*, at the time the loss is realized, among holders of paid-in capital issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. To the extent that paid-in capital funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(c) Attached to this disclosure is a statement that describes the amount of perpetual capital the credit union has with the corporate credit union in each of the categories described in paragraphs (5)(a) and (5)(b) above.

(6) Where the corporate credit union is liquidated:

(a) Paid-in capital accounts issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including contributed capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. However, paid-in capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

(b) Paid-in capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, nonperpetual accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] and contributed capital accounts issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

However, paid-in capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

(7) Where the corporate credit union is merged into another corporate credit union, the paid-in capital account will transfer to the continuing corporate credit union.

(8) Paid-in capital is perpetual maturity and noncumulative dividend.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the paid-in capital instrument.

The notice form must be signed by either all of the directors of the credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

## MODEL FORM G

### Terms and Conditions of Perpetual Contributed Capital

[NOTE: This form is for use on and after [INSERT DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined NOT to give newly issued capital priority over older capital as described in Part I of this Appendix. Also, capital previously issued under the nomenclature "paid-in capital" is considered perpetual contributed capital.]

(1) A perpetual contributed capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A perpetual contributed capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the perpetual contributed capital account transfers to the continuing credit union. In the event of a charter conversion, the perpetual contributed capital account transfers to the new institution. In the event of

liquidation, the perpetual contributed capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called. The corporate must also obtain the prior, written approval of the NCUA before releasing any perpetual contributed capital funds.

(4) Perpetual contributed capital cannot be used to pledge borrowings.

(5) Perpetual contributed capital is perpetual maturity and noncumulative dividend.

(6) Perpetual contributed capital is available to cover losses that exceed retained earnings. Any such losses must be distributed *pro rata* among perpetual contributed capital holders at the time the loss is realized. To the extent that perpetual contributed capital funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(7) Where the corporate credit union is liquidated, perpetual contributed capital accounts are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, and nonperpetual capital holders. However, perpetual contributed capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and conditions of the perpetual contributed capital instrument.

The notice form must be signed by either all of the directors of the credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

MODEL FORM H

Terms and Conditions of Perpetual Contributed Capital

[NOTE: This form is for use before [INSERT DATE 12 MONTHS AFTER PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER] in the circumstances where the credit union has determined THAT IT WILL give newly issued capital priority over older capital as described in Part I of this Appendix. Also, capital previously issued under the nomenclature “paid-in capital” is considered perpetual contributed capital].

(1) A perpetual contributed capital account is not subject to share insurance coverage by the NCUSIF or other deposit insurer.

(2) A perpetual contributed capital account is not releasable due solely to the merger, charter conversion or liquidation of the member credit union. In the event of a merger, the perpetual contributed capital account transfers to the continuing credit union. In the event of a charter conversion, the perpetual contributed capital account transfers to the new institution. In the event of liquidation, the perpetual contributed capital account may be released to facilitate the payout of shares with the prior written approval of NCUA.

(3) The funds are callable only at the option of the corporate credit union and only if the corporate credit union meets its minimum required capital and NEV ratios after the funds are called. The corporate must also obtain the prior, written approval of the NCUA before releasing any perpetual contributed capital funds.

(4) Perpetual contributed capital cannot be used to pledge borrowings.

(5) Perpetual contributed capital is perpetual maturity and noncumulative dividend.

(6) Availability to cover losses.

(a) Perpetual contributed capital issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] is available to cover losses that exceed retained earnings. Any such losses must be distributed pro rata, at the time the loss is realized, among holders of perpetual contributed capital issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. To the extent that perpetual contributed capital funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(b) Perpetual contributed capital issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] is available to cover losses that exceed retained earnings and any contributed capital issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. Any such losses must be distributed *pro rata*, at the time the loss is realized, among holders of perpetual contributed capital issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. To the extent that perpetual contributed capital funds are used to cover losses, the corporate credit union is prohibited from restoring or replenishing the affected accounts under any circumstances.

(c) Attached to this disclosure is a statement that describes the amount of perpetual capital the credit union has with the corporate credit union in each of the categories described in paragraphs (6)(a) and (6)(b) above.

(7) Where the corporate credit union is liquidated:

(a) Perpetual contributed capital accounts issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, but not including contributed capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. However, perpetual contributed capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

(b) Perpetual contributed capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER] are payable only after satisfaction of all liabilities of the liquidation estate including uninsured obligations to shareholders and the NCUSIF, nonperpetual capital accounts issued before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], and all contributed capital accounts issued on or after [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]. However, perpetual contributed capital that is used to cover losses in a calendar year previous to the year of liquidation has no claim against the liquidation estate.

I have read the above terms and conditions and I understand them. I further agree to maintain in the credit union's files the annual notice of terms and

conditions of the perpetual contributed capital instrument.

The notice form must be signed by either all of the directors of the credit union or, if authorized by board resolution, the chair and secretary of the board of the credit union.

21. Revise Appendix B to Part 704 to read as follows:

#### Appendix B to Part 704 — Expanded Authorities and Requirements

A corporate credit union may obtain all or part of the expanded authorities contained in this Appendix if it meets the applicable requirements of Part 704 and Appendix B, fulfills additional management, infrastructure, and asset and liability requirements, and receives NCUA's written approval. Additional guidance is set forth in the NCUA publication Guidelines for Submission of Requests for Expanded Authority.

A corporate credit union seeking expanded authorities must submit to NCUA a self-assessment plan supporting its request. A corporate credit union may adopt expanded authorities when NCUA has provided final approval. If NCUA denies a request for expanded authorities, it will advise the corporate credit union of the reason(s) for the denial and what it must do to resubmit its request. NCUA may revoke these expanded authorities at any time if an analysis indicates a significant deficiency. NCUA will notify the corporate credit union in writing of the identified deficiency. A corporate credit union may request, in writing, reinstatement of the revoked authorities by providing a self-assessment plan detailing how it has corrected the deficiency.

A state chartered corporate credit union may not exercise any expanded authority that exceeds the powers and authorities provided for under its state laws. Accordingly, requests by state chartered corporate credit unions for expansions under this part must be approved by the state regulator before being submitted to NCUA.

#### Minimum Requirement

In order to participate in any of the authorities set forth in Base-Plus, Part I, Part II, Part III, or Part IV of this Appendix, a corporate credit union must evaluate monthly, including once on the last day of the month, the changes in NEV, NEV

ratio, NII, WAL, and duration as required by paragraphs (d)(1)(i), (e), (f), (g), and (i) of §704.8.

## BASE-PLUS

A corporate that has met the requirements for this Base-plus authority may, in performing the rate stress tests set forth in 704.8(d)(1)(i), allow its NEV to decline as much as 20 percent.

## PART I

(a) A corporate credit union that has met all the requirements established by NCUA for this Part I, including a minimum capital ratio of at least six percent, may:

- (1) Purchase investments with long-term ratings no lower than A– (or equivalent);
- (2) Purchase investments with short-term ratings no lower than A–2 (or equivalent), provided that the issuer has a long-term rating no lower than A– (or equivalent) or the investment is a domestically-issued asset-backed security;
- (3) Engage in short sales of permissible investments to reduce interest rate risk;
- (4) Purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and
- (5) Enter into a dollar roll transaction.

(b) In performing the rate stress tests set forth in §704.8(d), the NEV of a corporate credit union that has met the requirements of this Part I may decline as much as:

- (1) 20 percent;

(2) 28 percent if the corporate credit union has a seven percent minimum capital ratio and is specifically approved by NCUA; or

(3) 35 percent if the corporate credit union has an eight percent minimum capital ratio and is specifically approved by NCUA.

(c) The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, must not exceed 100 percent of the corporate credit union's capital. The board of directors must establish the limit, as a percent of the corporate credit union's capital plus pledged shares, for secured loans and lines of credit.

(d) The aggregate total of investments purchased under the authority of Part I (a)(1) and Part I (a)(2) may not exceed the lower of 500 percent of the corporate credit union's capital or 25 percent of assets.

(e) On or after [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], corporate credit unions will substitute "leverage ratio" for "capital ratio" wherever it appears in Part I.

## PART II

(a) A corporate credit union that has met the requirements of Part I of this Appendix and the additional requirements established by NCUA for Part II may invest in:

(1) Debt obligations of a foreign country;

(2) Deposits and debt obligations of foreign banks or obligations guaranteed by these banks;

(3) Marketable debt obligations of foreign corporations. This authority does not apply to debt obligations that are convertible into the stock of the corporation; and

(4) Foreign issued asset-backed securities.

(b) All foreign investments are subject to the following requirements:

(1) Investments must be rated no lower than the minimum permissible domestic rating under the corporate credit union's Part I authority;

(2) A sovereign issuer, and/or the country in which an obligor is organized, must have a long-term foreign currency (non-local currency) debt rating no lower than AA- (or equivalent);

(3) For each approved foreign bank line, the corporate credit union must identify the specific banking centers and branches to which it will lend funds;

(4) Obligations of any single foreign obligor may not exceed 25 percent of capital or \$5 million, whichever is greater; and

(5) Obligations in any single foreign country may not exceed 250 percent of capital.

### PART III

(a) A corporate credit union that has met the requirements established by NCUA for this Part III may enter into derivative transactions specifically approved by NCUA to:

(1) Create structured products;

(2) Mitigate interest rate risk and credit risk on its own balance sheet; and

(3) Hedge the balance sheets of its members.

(b) Credit Ratings:

(1) All derivative transactions are subject to the following requirements:

(i) If the intended counterparty is domestic, the counterparty rating must be no lower than A- (or equivalent) by every NRSRO that provides a publicly available long-term rating on the counterparty;

(ii) If the intended counterparty is foreign, the corporate must have Part II expanded authority and the counterparty rating must be no lower than the minimum permissible rating for a comparable term investment under Part II Authority;

(iii) The corporate must identify the rating(s) relied upon to meet the requirements of this part at the time the transaction is entered into and monitor those ratings for as long as the contract remains open; and

(iv) The corporate credit unions must comply with §704.10 of this part if any rating relied upon to meet the requirements of paragraphs (b)(1)(i) or (ii) of this part is downgraded below the minimum rating requirements.

(2) Exceptions. Credit ratings are not required for derivative transactions with:

(i) Domestically chartered credit unions;

(ii) U.S. government sponsored enterprises; or

(iii) Counterparties where the transaction is fully guaranteed by an entity with a minimum permissible rating for comparable term investments.

## PART IV

A corporate credit union that has met all the requirements established by NCUA for this Part IV may participate in loans with member natural person credit unions as approved by the NCUA and subject to the following:

(a) The maximum aggregate amount of participation loans with any one member credit union must not exceed 25 percent of capital; and

(b) The maximum aggregate amount of participation loans with all member credit unions will be determined on a case-by-case basis by the NCUA

22. Add a new Appendix C to Part 704 to read as follows:

Appendix C to Part 704 – Risk-Based Capital Credit Risk-Weight Categories.

#### Table of Contents

- I. Introduction
  - (a) Scope
  - (b) Definitions
  
- II. Risk-Weightings
  - (a) On-balance sheet assets
  - (b) Off-balance sheet activities
  - (c) Recourse obligations, direct credit substitutes, and certain other positions

#### Part I: Introduction

#### Section I.

(a) Scope.

(1) This Appendix explains how a corporate credit union must compute its risk-weighted assets for purposes of determining its capital ratios.

(2) Risk-weighted assets equal risk-weighted on-balance sheet assets (computed under Section II(a) of this Appendix), plus risk-weighted off-balance sheet activities (computed under Section II(b) of this Appendix), plus risk-weighted recourse obligations, direct credit substitutes, and certain other positions (computed under Section II(c) of this Appendix).

(3) Assets not included (i.e., deducted from capital) for purposes of calculating capital under part 704 are not included in calculating risk-weighted assets.

(4) Although this Appendix describes risk-weightings for various assets and activities, this Appendix does not provide authority for corporate credit unions to invest in or purchase any particular type of asset or to engage in any particular type of activity. A corporate credit union must have other identifiable authority for any investment it makes or activity it engages in. So, for example, this Appendix describes risk weightings for subordinated securities. Section §704.5, however, prohibits corporate credit unions from investing in subordinated securities, and so a corporate credit union cannot invest in subordinated securities.

(b) Definitions.

The following definitions apply to this Appendix. Additional definitions, applicable to this entire Part, are located in §704.2 of this Part.

**Cash items in the process of collection** means checks or drafts in the process of collection that are drawn on another depository institution, including a central bank, and that are payable immediately upon presentation; U.S. Government checks that are drawn on the United States Treasury or any other U.S. Government or Government-sponsored agency and that are payable immediately upon presentation; broker's security drafts and commodity or bill-of-lading drafts payable immediately upon presentation; and unposted debits.

**Commitment** means any arrangement that obligates a corporate credit union to:

(1) Purchase loans or securities;

(2) Extend credit in the form of loans or leases, participations in loans or leases, overdraft facilities, revolving credit facilities, home equity lines of credit, eligible ABCP liquidity facilities, or similar transactions.

**Depository institution** means a financial institution that engages in the business of providing financial services; that is recognized as a bank or a credit union by the supervisory or monetary authorities of the country of its incorporation and the country of its principal banking operations; that receives deposits to a substantial extent in the regular course of business; and that has the power to accept demand deposits. In the United States, this definition encompasses all federally insured offices of commercial banks, mutual and stock savings banks, savings or building and loan associations (stock and mutual), cooperative banks, credit unions, and international banking facilities of domestic depository institutions. Bank holding companies and savings and loan holding companies are excluded from this definition. For the purposes of assigning risk-weights, the differentiation between OECD depository institutions and non-OECD depository institutions is based on the country of incorporation. Claims on branches and agencies of foreign banks located in the United States are to be categorized on the basis of the parent bank's country of incorporation.

**Direct credit substitute** means an arrangement in which a corporate credit union assumes, in form or in substance, credit risk associated with an on-balance sheet or off-balance sheet asset or exposure that was not previously owned by the corporate credit union (third-party asset) and the risk assumed by the corporate credit union exceeds the pro rata share of the corporate credit union's interest in the third-party asset. If a corporate credit union has no claim on the third-party asset, then the corporate credit union's assumption of any credit risk is a direct credit substitute. Direct credit substitutes include:

- (1) Financial standby letters of credit that support financial claims on a third party that exceed a corporate credit union's pro rata share in the financial claim;
- (2) Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed a corporate credit union's pro rata share in the financial claim;
- (3) Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets, including any tranche of asset-backed securities that is not the most senior tranche;
- (4) Credit derivative contracts under which the corporate credit union assumes more than its pro rata share of credit risk on a third-party asset or exposure;

(5) Loans or lines of credit that provide credit enhancement for the financial obligations of a third party;

(6) Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Servicer cash advances as defined in this section are not direct credit substitutes;

(7) Clean-up calls on third party assets. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the corporate credit union are not direct credit substitutes; and

(8) Liquidity facilities that provide support to asset-backed commercial paper (other than eligible ABCP liquidity facilities).

**Exchange rate contracts** means cross-currency interest rate swaps; forward foreign exchange rate contracts; currency options purchased; and any similar instrument that, in the opinion of the NCUA, may give rise to similar risks.

**Face amount** means the notational principal, or face value, amount of an off-balance sheet item or the amortized cost of an on-balance sheet asset.

**Financial asset** means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

**Financial standby letter of credit** means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

(1) To repay money borrowed by, or advanced to, or for the account of, a second party (the account party); or

(2) To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

**OECD-based country** means a member of that grouping of countries that are full members of the Organization for Economic Cooperation and Development (OECD) plus countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the IMF's General Arrangements to Borrow. This term excludes any country that has rescheduled its external sovereign debt within the previous five years. A rescheduling of external sovereign debt generally would include any renegotiation of terms arising from a country's inability or unwillingness to meet its external debt service obligations, but generally would not include renegotiations of debt in the normal

course of business, such as a renegotiation to allow the borrower to take advantage of a decline in interest rates or other change in market conditions.

**Original maturity** means, with respect to a commitment, the earliest date after a commitment is made on which the commitment is scheduled to expire (i.e., it will reach its stated maturity and cease to be binding on either party), provided that either:

- (1) The commitment is not subject to extension or renewal and will actually expire on its stated expiration date; or
- (2) If the commitment is subject to extension or renewal beyond its stated expiration date, the stated expiration date will be deemed the original maturity only if the extension or renewal must be based upon terms and conditions independently negotiated in good faith with the member at the time of the extension or renewal and upon a new, bona fide credit analysis utilizing current information on financial condition and trends.

**Performance-based standby letter of credit** means any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment on account of any default by a third party in the performance of a nonfinancial or commercial obligation. Such letters of credit include arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

**Prorated assets** means the total assets (as determined in the most recently available GAAP report but in no event more than one year old) of a consolidated CUSO multiplied by the corporate credit union's percentage of ownership of that consolidated CUSO.

**Qualifying mortgage loan** means a loan that:

- (1) Is fully secured by a first lien on a one-to four-family residential property;
- (2) Is underwritten in accordance with prudent underwriting standards, including standards relating the ratio of the loan amount to the value of the property (LTV ratio), as presented in the Interagency Guidelines for Real Estate Lending Policies, 57 Fed. Reg. 62890 (December 31, 1992). A nonqualifying mortgage loan that is paid down to an appropriate LTV ratio (calculated using value at origination, appraisal obtained within the prior six months, or updated value using an automated valuation model) may become a qualifying loan if it meets all other requirements of this definition;

(3) Maintains an appropriate LTV ratio based on the amortized principal balance of the loan; and

(4) Is performing and is not more than 90 days past due.

If a corporate credit union holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purposes of determining the LTV ratio and the appropriate risk-weight under Appendix C. Also, a loan to an individual borrower for the construction of the borrower's home may be included as a qualifying mortgage loan.

***Qualifying multifamily mortgage loan*** means a loan secured by a first lien on multifamily residential properties consisting of 5 or more dwelling units, provided that:

(1) The amortization of principal and interest occurs over a period of not more than 30 years;

(2) The original minimum maturity for repayment of principal on the loan is not less than seven years;

(3) When considering the loan for placement in a lower risk-weight category, all principal and interest payments have been made on a timely basis in accordance with its terms for the preceding year;

(4) The loan is performing and not 90 days or more past due;

(5) The loan is made in accordance with prudent underwriting standards; and

(6) If the interest rate on the loan does not change over the term of the loan, the current loan balance amount does not exceed 80 percent of the value of the property securing the loan, and for the property's most recent calendar year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 120 percent, or in the case of cooperative or other not-for-profit housing projects, the property generates sufficient cash flows to provide comparable protection to the institution; or

(7) If the interest rate on the loan changes over the term of the loan, the current loan balance amount does not exceed 75 percent of the value of the property securing the loan, and for the property's most recent calendar year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 115

percent, or in the case of cooperative or other not-for-profit housing projects, the property generates sufficient cash flows to provide comparable protection to the institution.

For purposes of paragraphs (6) and (7) of this definition, the term value of the property means, at origination of a loan to purchase a multifamily property, the lower of the purchase price or the amount of the initial appraisal, or if appropriate, the initial evaluation. In cases not involving purchase of a multifamily loan, the value of the property is determined by the most current appraisal, or if appropriate, the most current evaluation.

In cases where a borrower refinances a loan on an existing property, as an alternative to paragraphs (3), (6), and (7) of this definition:

(1) All principal and interest payments on the loan being refinanced have been made on a timely basis in accordance with the terms of that loan for the preceding year; and

(2) The net income on the property for the preceding year would support timely principal and interest payments on the new loan in accordance with the applicable debt service requirement.

***Qualifying residential construction loan***, also referred to as a residential bridge loan, means a loan made in accordance with sound lending principles satisfying the following criteria:

(1) The builder must have substantial project equity in the home construction project;

(2) The residence being constructed must be a 1-4 family residence sold to a home purchaser;

(3) The lending entity must obtain sufficient documentation from a permanent lender (which may be the construction lender) demonstrating that the home buyer intends to purchase the residence and has the ability to obtain a permanent qualifying mortgage loan sufficient to purchase the residence;

(4) The home purchaser must have made a substantial earnest money deposit;

(5) The construction loan must not exceed 80 percent of the sales price of the residence;

(6) The construction loan must be secured by a first lien on the lot, residence under construction, and other improvements;

- (7) The lending credit union must retain sufficient undisbursed loan funds throughout the construction period to ensure project completion;
- (8) The builder must incur a significant percentage of direct costs (i.e., the actual costs of land, labor, and material) before any drawdown on the loan;
- (9) If at any time during the life of the construction loan any of the criteria of this rule are no longer satisfied, the corporate must immediately recategorize the loan at a 100 percent risk-weight and must accurately report the loan in the corporate's next quarterly call report;
- (10) The home purchaser must intend that the home will be owner-occupied;
- (11) The home purchaser(s) must be an individual(s), not a partnership, joint venture, trust corporation, or any other entity (including an entity acting as a sole proprietorship) that is purchasing the home(s) for speculative purposes; and
- (12) The loan must be performing and not more than 90 days past due.

The NCUA retains the discretion to determine that any loans not meeting sound lending principles must be placed in a higher risk-weight category. The NCUA also reserves the discretion to modify these criteria on a case-by-case basis provided that any such modifications are not inconsistent with the safety and soundness objectives of this definition.

***Qualifying securities firm*** means:

- (1) A securities firm incorporated in the United States that is a broker-dealer that is registered with the Securities and Exchange Commission (SEC) and that complies with the SEC's net capital regulations (17 CFR 240.15c3(1)); and
- (2) A securities firm incorporated in any other OECD-based country, if the corporate credit union is able to demonstrate that the securities firm is subject to consolidated supervision and regulation (covering its subsidiaries, but not necessarily its parent organizations) comparable to that imposed on depository institutions in OECD countries. Such regulation must include risk-based capital requirements comparable to those imposed on depository institutions under the Accord on International Convergence of Capital Measurement and Capital Standards (1988, as amended in 1998).

***Recourse*** means a corporate credit union's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold (in accordance with Generally Accepted Accounting Principles) that exceeds a pro

rata share of that corporate credit union's claim on the asset. If a corporate credit union has no claim on an asset it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when a corporate credit union transfers assets in a sale and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a corporate credit union provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include:

- (1) Credit-enhancing representations and warranties made on transferred assets;
- (2) Loan servicing assets retained pursuant to an agreement under which the corporate credit union will be responsible for losses associated with the loans serviced. Servicer cash advances as defined in this section are not recourse obligations;
- (3) Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets;
- (4) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet;
- (5) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;
- (6) Credit derivatives that absorb more than the corporate credit union's pro rata share of losses from the transferred assets;
- (7) Clean-up calls on assets the corporate credit union has sold. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the corporate credit union are not recourse arrangements; and
- (8) Liquidity facilities that provide support to asset-backed commercial paper (other than eligible ABCP liquidity facilities).

**Replacement cost** means, with respect to interest rate and exchange-rate contracts, the loss that would be incurred in the event of a counterparty default, as measured by the net cost of replacing the contract at the current market value. If default would result in a theoretical profit, the replacement value is considered

to be zero. This mark-to-market process must incorporate changes in both interest rates and counterparty credit quality.

**Residential properties** means houses, condominiums, cooperative units, and manufactured homes. This definition does not include boats or motor homes, even if used as a primary residence, or timeshare properties.

**Residual interest** means any on-balance sheet asset that:

- (1) Represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with Generally Accepted Accounting Principles) of financial assets, whether through a securitization or otherwise; and
- (2) Exposes a corporate credit union to credit risk directly or indirectly associated with the transferred asset that exceeds a *pro rata* share of that corporate credit union's claim on the asset, whether through subordination provisions or other credit enhancement techniques.

Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests (and other forms of overcollateralization), and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the corporate credit union to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include assets purchased from a third party, but a credit-enhancing interest-only strip that is acquired in any asset transfer is a residual interest.

Corporate credit unions will use this definition of the term “residual interests,” and not the definition in §704.2, for purposes of applying this Appendix.

**Risk participation** means a participation in which the originating party remains liable to the beneficiary for the full amount of an obligation (e.g., a direct credit substitute), notwithstanding that another party has acquired a participation in that obligation.

**Risk-weighted assets** means the sum total of risk-weighted on-balance sheet assets, as calculated under Section II(a) of this Appendix, and the total of risk-weighted off-balance sheet credit equivalent amounts. The total of risk-weighted off-balance sheet credit equivalent amounts equals the risk-weighted off-balance sheet activities as calculated under Section II(b) of this Appendix plus the risk-weighted recourse obligations, risk-weighted direct credit substitutes, and certain other risk-weighted positions as calculated under Section II(c) of this Appendix.

***Servicer cash advance*** means funds that a residential mortgage servicer advances to ensure an uninterrupted flow of payments, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the loan. A servicer cash advance is not a recourse obligation or a direct credit substitute if:

- (1) The servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or
- (2) For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal amount on that loan.

***Structured financing program*** means a program where receivable interests and asset-or mortgage-backed securities issued by multiple participants are purchased by a special purpose entity that repackages those exposures into securities that can be sold to investors. Structured financing programs allocate credit risk, generally, between the participants and credit enhancement provided to the program.

***Traded position*** means a position retained, assumed, or issued in connection with a securitization that is rated by a NRSRO, where there is a reasonable expectation that, in the near future, the rating will be relied upon by:

- (1) Unaffiliated investors to purchase the security; or
- (2) An unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

***Unconditionally cancelable*** means, with respect to a commitment-type lending arrangement, that the corporate credit union may, at any time, with or without cause, refuse to advance funds or extend credit under the facility.

***United States Government or its agencies*** means an instrumentality of the U.S. Government whose debt obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the United States Government.

***United States Government-sponsored agency or corporation*** means an

agency or corporation originally established or chartered to serve public purposes specified by the United States Congress but whose obligations are not explicitly guaranteed by the full faith and credit of the United States Government.

## Part II: Risk-Weightings

### Section II.

#### (a) On-balance sheet assets.

Except as provided in Section II(b) of this Appendix, risk-weighted on-balance sheet assets are computed by multiplying the on-balance sheet asset amounts times the appropriate risk-weight categories. The risk-weight categories are:

#### (1) Zero percent Risk-Weight (Category 1).

(i) Cash, including domestic and foreign currency owned and held in all offices of a corporate credit union or in transit. Any foreign currency held by a corporate credit union must be converted into U.S. dollar equivalents;

(ii) Securities issued by and other direct claims on the U.S. Government or its agencies (to the extent such securities or claims are unconditionally backed by the full faith and credit of the United States Government) or the central government of an OECD country;

(iii) Notes and obligations issued or guaranteed by the Federal Deposit Insurance Corporation or the National Credit Union Share Insurance Fund and backed by the full faith and credit of the United States Government;

(iv) Deposit reserves at, claims on, and balances due from Federal Reserve Banks;

(v) The book value of paid-in Federal Reserve Bank stock;

(vi) That portion of assets directly and unconditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country.

(viii) Claims on, and claims guaranteed by, a qualifying securities firm that are

collateralized by cash on deposit in the corporate credit union or by securities issued or guaranteed by the United States Government or its agencies, or the central government of an OECD country. To be eligible for this risk-weight, the corporate credit union must maintain a positive margin of collateral on the claim on a daily basis, taking into account any change in a corporate credit union's exposure to the obligor or counterparty under the claim in relation to the market value of the collateral held in support of the claim.

(2) 20 percent Risk-Weight (Category 2).

(i) Cash items in the process of collection;

(ii) That portion of assets conditionally guaranteed by the United States Government or its agencies, or the central government of an OECD country;

(iii) That portion of assets collateralized by the current market value of securities issued or guaranteed by the United States government or its agencies, or the central government of an OECD country;

(iv) Securities (not including equity securities) issued by and other claims on the U.S. Government or its agencies which are not backed by the full faith and credit of the United States Government;

(v) Securities (not including equity securities) issued by, or other direct claims on, United States Government-sponsored agencies;

(vi) That portion of assets guaranteed by United States Government-sponsored agencies;

(vii) That portion of assets collateralized by the current market value of securities issued or guaranteed by United States Government-sponsored agencies;

(viii) Claims on, and claims guaranteed by, a qualifying securities firm, subject to the following conditions:

(A) A qualifying securities firm must have a long-term issuer credit rating, or a rating on at least one issue of long-term unsecured debt, from a NRSRO. The rating must be in one of the three highest investment grade categories used by the NRSRO. If two or more NRSROs assign ratings to the qualifying securities firm, the corporate credit union must use the lowest rating to determine whether the rating requirement of this paragraph is met. A qualifying securities firm may rely on the rating of its parent consolidated company, if the parent consolidated

company guarantees the claim.

(B) A collateralized claim on a qualifying securities firm does not have to comply with the rating requirements under paragraph (a) if the claim arises under a contract that:

(1) Is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed using standard industry documentation;

(2) Is collateralized by debt or equity securities that are liquid and readily marketable;

(3) Is marked-to-market daily;

(4) Is subject to a daily margin maintenance requirement under the standard industry documentation; and

(5) Can be liquidated, terminated or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or avoided under applicable law of the relevant jurisdiction. For example, a claim is exempt from the automatic stay in bankruptcy in the United States if it arises under a securities contract or a repurchase agreement subject to [Section 555](#) or [559 of the Bankruptcy Code \(11 U.S.C. 555](#) or 559), a qualified financial contract under Section 207(c)(8) of the Federal Credit Union Act (12 U.S.C. 1787(c)(8)) or Section 11(e)(8) of the Federal Deposit Insurance Act ([12 U.S.C. 1821\(e\)\(8\)](#)), or a netting contract between or among financial institutions under Sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 ([12 U.S.C. 4401-4407](#)), or Regulation EE (12 CFR part 231).

(C) If the securities firm uses the claim to satisfy its applicable capital requirements, the claim is not eligible for a risk-weight under this paragraph II(a)(2)(viii);

(ix) Claims representing general obligations of any public-sector entity in an OECD country, and that portion of any claims guaranteed by any such public-sector entity;

(x) Balances due from and all claims on domestic depository institutions. This includes demand deposits and other transaction accounts, savings deposits and time certificates of deposit, federal funds sold, loans to other depository institutions, including overdrafts and term federal funds, holdings of the corporate credit union's own discounted acceptances for which the account party is a depository institution, holdings of bankers acceptances of other institutions and securities issued by depository institutions, except those that qualify as capital;

- (xi) The book value of paid-in Federal Home Loan Bank stock;
  - (xii) Deposit reserves at, claims on and balances due from the Federal Home Loan Banks;
  - (xiii) Assets collateralized by cash held in a segregated deposit account by the reporting corporate credit union;
  - (xiv) Claims on, or guaranteed by, official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member;<sup>40</sup>
  - (xv) That portion of assets collateralized by the current market value of securities issued by official multilateral lending institutions or regional development institutions in which the United States Government is a shareholder or contributing member.
  - (xvi) All claims on depository institutions incorporated in an OECD country, and all assets backed by the full faith and credit of depository institutions incorporated in an OECD country. This includes the credit equivalent amount of participations in commitments and standby letters of credit sold to other depository institutions incorporated in an OECD country, but only if the originating bank remains liable to the member or beneficiary for the full amount of the commitment or standby letter of credit. Also included in this category are the credit equivalent amounts of risk participations in bankers' acceptances conveyed to other depository institutions incorporated in an OECD country. However, bank-issued securities that qualify as capital of the issuing bank are not included in this risk category;
  - (xvii) Claims on, or guaranteed by depository institutions other than the central bank, incorporated in a non-OECD country, with a remaining maturity of one year or less;
  - (xviii) That portion of local currency claims conditionally guaranteed by central governments of non-OECD countries, to the extent the corporate credit union has local currency liabilities in that country.
- (3) 50 percent Risk-Weight (Category 3).

---

<sup>40</sup> These institutions include, but are not limited to, the International Bank for Reconstruction and Development (World Bank), the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investments Bank, the International Monetary Fund and the Bank for International Settlements.

(i) Revenue bonds issued by any public-sector entity in an OECD country for which the underlying obligor is a public- sector entity, but which are repayable solely from the revenues generated from the project financed through the issuance of the obligations;

(ii) Qualifying mortgage loans and qualifying multifamily mortgage loans;

(iii) Privately-issued mortgage-backed securities (i.e., those that do not carry the guarantee of the U.S. Government, a U.S. government agency, or a U.S. government sponsored enterprise) representing an interest in qualifying mortgage loans or qualifying multifamily mortgage loans. If the security is backed by qualifying multifamily mortgage loans, the corporate credit union must receive timely payments of principal and interest in accordance with the terms of the security. Payments will generally be considered timely if they are not 30 days past due; and

(iv) Qualifying residential construction loans.

(4) 100 percent Risk-Weight (Category 4).

All assets not specified above or deducted from calculations of capital pursuant to §704.2 and §704.3 of this part, including, but not limited to:

(i) Consumer loans;

(ii) Commercial loans;

(iii) Home equity loans;

(iv) Non-qualifying mortgage loans;

(v) Non-qualifying multifamily mortgage loans;

(vi) Residential construction loans;

(vii) Land loans;

(viii) Nonresidential construction loans;

(ix) Obligations issued by any state or any political subdivision thereof for the benefit of a private party or enterprise where that party or enterprise, rather than the issuing state or political subdivision, is responsible for the timely payment of principal and interest on the obligations, e.g., industrial development bonds;

- (x) Debt securities not specifically risk-weighted in another category;
- (xi) Investments in fixed assets and premises;
- (xii) Servicing assets;
- (xiii) Interest-only strips receivable, other than credit-enhancing interest-only strips;
- (xiv) Equity investments;
- (xv) The prorated assets of subsidiaries (except for the assets of consolidated CUSOs) to the extent such assets are included in adjusted total assets;
- (xvi) All repossessed assets or assets that are more than 90 days past due; and
- (xix) Intangible assets not specifically weighted in some other category.

(5) Indirect ownership interests in pools of assets. Assets representing an indirect holding of a pool of assets, e.g., mutual funds, are assigned to risk-weight categories under this section based upon the risk-weight that would be assigned to the assets in the portfolio of the pool. An investment in shares of a mutual fund whose portfolio consists primarily of various securities or money market instruments that, if held separately, would be assigned to different risk-weight categories, generally is assigned to the risk-weight category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the investment objectives set forth in its prospectus. The corporate credit union may, at its option, assign the investment on a *pro rata* basis to different risk-weight categories according to the investment limits in its prospectus. In no case will an investment in shares in any such fund be assigned to a total risk-weight less than 20 percent. If the corporate credit union chooses to assign investments on a *pro rata* basis, and the sum of the investment limits of assets in the fund's prospectus exceeds 100 percent, the corporate credit union must assign the highest *pro rata* amounts of its total investment to the higher risk categories. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk-weight, such securities will generally be disregarded in determining the risk-weight category into which the corporate credit union's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk-weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase

the risk-weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk-weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk-weight category.

(6) Derivatives. Certain transactions or activities, such as derivatives transactions, may appear on a corporate's balance sheet but are not specifically described in the Section II(a) on-balance sheet risk-weight categories. These items will be assigned risk-weights as described in Section II(b) or II(c) below.

(b) Off-balance sheet items.

Except as provided in Section II(c) of this Appendix, risk-weighted off-balance sheet items are determined by the following two-step process. First, the face amount of the off-balance sheet item must be multiplied by the appropriate credit conversion factor listed in this Section II(b). This calculation translates the face amount of an off-balance sheet exposure into an on-balance sheet credit-equivalent amount. Second, the credit-equivalent amount must be assigned to the appropriate risk-weight category using the criteria regarding obligors, guarantors, and collateral listed in Section II(a) of this Appendix.<sup>41</sup> The following are the credit conversion factors and the off-balance sheet items to which they apply.

(1) 100 percent credit conversion factor (Group A).

(i) Risk participations purchased in bankers' acceptances;

(ii) Forward agreements and other contingent obligations with a certain draw down, e.g., legally binding agreements to purchase assets at a specified future date. On the date a corporate credit union enters into a forward agreement or similar obligation, it should convert the principal amount of the assets to be purchased at 100 percent as of that date and then assign this amount to the risk-weight category appropriate to the obligor or guarantor of the item, or the nature of the collateral;

---

<sup>41</sup> The sufficiency of collateral and guarantees for off-balance sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under paragraph II(d) of this Appendix C.

(iii) Indemnification of members whose securities the corporate credit union has lent as agent. If the member is not indemnified against loss by the corporate credit union, the transaction is excluded from the risk-based capital calculation. When a corporate credit union lends its own securities, the transaction is treated as a loan. When a corporate credit union lends its own securities or is acting as agent, agrees to indemnify a member, the transaction is assigned to the risk-weight appropriate to the obligor or collateral that is delivered to the lending or indemnifying institution or to an independent custodian acting on their behalf; and

(iv) Unused portions of ABCP liquidity facilities that do not meet the definition of an eligible ABCP liquidity facility. The resulting credit equivalent amount is assigned to the risk category appropriate to the assets to be funded by the liquidity facility based on the assets or the obligor, after considering any collateral or guarantees, or external credit ratings under paragraph II(c)(3) of this Appendix, if applicable.

(2) 50 percent credit conversion factor (Group B).

(i) Transaction-related contingencies, including, among other things, performance bonds and performance-based standby letters of credit related to a particular transaction;

(ii) Unused portions of commitments (including home equity lines of credit and eligible ABCP liquidity facilities) with an original maturity exceeding one year except those listed in paragraph II(b)(5) of this Appendix. For eligible ABCP liquidity facilities, the resulting credit equivalent amount is assigned to the risk category appropriate to the assets to be funded by the liquidity facility based on the assets or the obligor, after considering any collateral or guarantees, or external credit ratings under paragraph II(c)(3) of this Appendix, if applicable; and

(iii) Revolving underwriting facilities, note issuance facilities, and similar arrangements pursuant to which the corporate credit union's CUSO or member can issue short-term debt obligations in its own name, but for which the corporate credit union has a legally binding commitment to either:

(A) Purchase the obligations the member is unable to sell by a stated date; or

(B) Advance funds to its member, if the obligations cannot be sold.

(3) 20 percent credit conversion factor (Group C). (i) Trade-related contingencies, i.e., short-term, self-liquidating instruments used to finance the

movement of goods and collateralized by the underlying shipment. A commercial letter of credit is an example of such an instrument.

(4) 10 percent credit conversion factor (Group D). Unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less. The resulting credit equivalent amount is assigned to the risk category appropriate to the assets to be funded by the liquidity facility based on the assets or the obligor, after considering any collateral or guarantees, or external credit ratings under paragraph II(c)(3) of this Appendix, if applicable;

(5) Zero percent credit conversion factor (Group E). (i) Unused portions of commitments with an original maturity of one year or less, except for eligible ABCP liquidity facilities;

(ii) Unused commitments with an original maturity greater than one year, if they are unconditionally cancelable at any time at the option of the corporate credit union and the corporate credit union has the contractual right to make, and in fact does make, either:

(A) A separate credit decision based upon the borrower's current financial condition before each drawing under the lending facility; or

(B) An annual (or more frequent) credit review based upon the borrower's current financial condition to determine whether or not the lending facility should be continued; and

(iii) The unused portion of retail credit card lines or other related plans that are unconditionally cancelable by the corporate credit union in accordance with applicable law.

(6) Off-balance sheet derivative contracts; interest rate and foreign exchange rate contracts (Group F). –

(i) Calculation of credit equivalent amounts. The credit equivalent amount of an off-balance sheet derivative contract that is not subject to a qualifying bilateral netting contract in accordance with paragraph II(b)(6)(ii) of this Appendix is equal to the sum of the current credit exposure, i.e., the replacement cost of the contract, and the potential future credit exposure of the contract. The calculation of credit equivalent amounts is measured in U.S. dollars, regardless of the currency or currencies specified in the contract.

(A) Current credit exposure. The current credit exposure of an off-balance sheet derivative contract is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current credit exposure equals that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. In determining its current credit exposure for multiple off-balance sheet derivative contracts executed with a single counterparty, a corporate credit union may net positive and negative mark-to-market values of off-balance sheet derivative contracts if subject to a bilateral netting contract as provided in paragraph II(b)(6)(ii) of this Appendix.

(B) Potential future credit exposure. The potential future credit exposure of an off-balance sheet derivative contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal by a credit conversion factor.<sup>42</sup> Corporate credit unions, subject to examiner review, should use the effective rather than the apparent or stated notional amount in this calculation. The conversion factors are:<sup>43</sup>

Remaining Maturity	Interest Rate Contracts (Percent)	Foreign Exchange Rate Contracts (Percent)	Other Derivative Contracts (Percent)
One year or less	0.0	1.0	10.0
Over one year but less than five years	0.50	5.0	12.0
Over five years	0.50	5.0	15.0

(ii) Off-balance sheet derivative contracts subject to bilateral netting contracts. In determining its current credit exposure for multiple off-balance sheet derivative contracts executed with a single counterparty, a corporate credit union may net off-balance sheet derivative contracts subject to a bilateral netting contract by offsetting positive and negative mark-to-market values, provided that:

<sup>42</sup> For purposes of calculating potential future credit exposure for foreign exchange contracts and other similar contracts, in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts to each party falling due on each value date in each currency.

<sup>43</sup> No potential future credit exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating rate indices, so-called floating/floating or basis swaps; the credit equivalent amount is measured solely on the basis of the current credit exposure.

(A) The bilateral netting contract is in writing;

(B) The bilateral netting contract creates a single legal obligation for all individual off-balance sheet derivative contracts covered by the bilateral netting contract. In effect, the bilateral netting contract provides that the corporate credit union has a single claim or obligation either to receive or pay only the net amount of the sum of the positive and negative mark-to-market values on the individual off-balance sheet derivative contracts covered by the bilateral netting contract. The single legal obligation for the net amount is operative in the event that a counterparty, or a counterparty to whom the bilateral netting contract has been validly assigned, fails to perform due to any of the following events: default, insolvency, bankruptcy, or other similar circumstances;

(C) The corporate credit union obtains a written and reasoned legal opinion(s) representing, with a high degree of certainty, that in the event of a legal challenge, including one resulting from default, insolvency, bankruptcy or similar circumstances, the relevant court and administrative authorities would find the corporate credit union's exposure to be the net amount under:

(1) The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

(2) The law that governs the individual off-balance sheet derivative contracts covered by the bilateral netting contract; and

(3) The law that governs the bilateral netting contract;

(D) The corporate credit union establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the bilateral netting contract continues to satisfy the requirements of this section; and

(E) The corporate credit union maintains in its files documentation adequate to support the netting of an off-balance sheet derivative contract.<sup>44</sup>

---

<sup>44</sup> By netting individual off-balance sheet derivative contracts for the purpose of calculating its credit equivalent amount, a corporate credit union represents that documentation adequate to support the netting of an off-balance sheet derivative contract is in the corporate credit union's files and available for inspection by the NCUA. Upon determination by the NCUA that a corporate credit union's files are inadequate or that a bilateral netting contract may not be legally enforceable under any one of the bodies of law described in paragraphs 11(b)(5)(ii) of this Appendix, the underlying individual off-balance sheet derivative contracts may not be netted for the purposes of this section.

(iii) Walkaway clause. A bilateral netting contract that contains a walkaway clause is not eligible for netting for purposes of calculating the current credit exposure amount. The term "walkaway clause" means a provision in a bilateral netting contract that permits a nondefaulting counterparty to make a lower payment than it would make otherwise under the bilateral netting contract, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the bilateral netting contract.

(iv) Risk-weighting. Once the corporate credit union determines the credit equivalent amount for an off-balance sheet derivative contract, that amount is assigned to the risk-weight category appropriate to the counterparty, or, if relevant, to the nature of any collateral or guarantee. Collateral held against a netting contract is not recognized for capital purposes unless it is legally available for all contracts included in the netting contract. However, the maximum risk-weight for the credit equivalent amount of such off-balance sheet derivative contracts is 50 percent.

(v) Exceptions. The following off-balance sheet derivative contracts are not subject to the above calculation, and therefore, are not part of the denominator of a corporate credit union's risk-based capital ratio:

(A) A foreign exchange rate contract with an original maturity of 14 calendar days or less; and

(B) Any interest rate or foreign exchange rate contract that is traded on an exchange requiring the daily payment of any variations in the market value of the contract.

(C) Asset-backed commercial paper programs.

(1) A corporate credit union that qualifies as a primary beneficiary and must consolidate an ABCP program that is a variable interest entity under Generally Accepted Accounting Principles may exclude the consolidated ABCP program assets from risk-weighted assets if the corporate credit union is the sponsor of the ABCP program.

(2) If a corporate credit union excludes such consolidated ABCP program assets from risk-weighted assets, the corporate credit union must assess the appropriate risk-based capital requirement against any exposures of the corporate credit union arising in connection with such ABCP programs, including direct credit substitutes, recourse obligations, residual interests, liquidity facilities, and loans, in accordance with Sections II(a), II(b), and II(c) of this Appendix.

(3) If a corporate credit union has multiple overlapping exposures (such as a program-wide credit enhancement and a liquidity facility) to an ABCP program that is not consolidated for risk-based capital purposes, the corporate credit union is not required to hold duplicative risk-based capital under this part against the overlapping position. Instead, the corporate credit union should apply to the overlapping position the applicable risk-based capital treatment that results in the highest capital charge.

(c) Recourse obligations, direct credit substitutes, and certain other positions.

(1) In general. Except as otherwise permitted in this Section II(c), to determine the risk-weighted asset amount for a recourse obligation or a direct credit substitute (but not a residual interest):

(i) Multiply the full amount of the credit-enhanced assets for which the corporate credit union directly or indirectly retains or assumes credit risk by a 100 percent conversion factor (For a direct credit substitute that is an on-balance sheet asset (e.g., a purchased subordinated security), a corporate credit union must use the amount of the direct credit substitute and the full amount of the asset its supports, i.e., all the more senior positions in the structure); and

(ii) Assign this credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. Section II(a) lists the risk-weight categories.

(2) Residual interests. Except as otherwise permitted under this Section II(c), a corporate credit union must maintain risk-based capital for residual interests as follows:

(i) Credit-enhancing interest-only strips. A corporate credit union must maintain risk-based capital for a credit-enhancing interest-only strip equal to the remaining amount of the strip even if the amount of risk-based capital that must be maintained exceeds the full risk-based capital requirement for the assets transferred.

(ii) Other residual interests. A corporate credit union must maintain risk-based capital for a residual interest (excluding a credit-enhancing interest-only strip) equal to the face amount of the residual interest, even if the amount of risk-based capital that must be maintained exceeds the full risk-based capital requirement for the assets transferred.

(iii) Residual interests and other recourse obligations. Where a corporate credit

union holds a residual interest (including a credit-enhancing interest-only strip) and another recourse obligation in connection with the same transfer of assets, the corporate credit union must maintain risk-based capital equal to the greater of:

(A) The risk-based capital requirement for the residual interest as calculated under Section II(c)(2)(i) through (ii) of this Appendix; or

(B) The full risk-based capital requirement for the assets transferred, subject to the low-level recourse rules under Section II(c)(5) of this Appendix.

(3) Ratings-based approach -- (i) Calculation. A corporate credit union may calculate the risk-weighted asset amount for an eligible position described in Section II(c)(3)(ii) of this section by multiplying the face amount of the position by the appropriate risk-weight determined in accordance with Table A or B of this section.

**Table A**

<b>Long term rating category</b>	<b>Risk-weight (In percent)</b>
Highest or second highest investment grade	20
Third highest investment grade	50
Lowest investment grade	100
One category below investment grade	200

**Table B**

<b>Short term rating category</b>	<b>Risk-weight (In percent)</b>
Highest investment grade	20
Second highest investment grade	50
Lowest investment grade	100

(ii) Eligibility.

(A) Traded positions. A position is eligible for the treatment described in paragraph II(c)(3)(i) of this Appendix if:

(1) The position is a corporate debt obligation with a remaining maturity of 120 days or less, a recourse obligation, a direct credit substitute, a residual interest, or an asset- or mortgage-backed security and is not a credit-enhancing interest-only strip;

(2) The position is a traded position; and

(3) The NRSRO has rated a long term position as one grade below investment grade or better or a short term position as investment grade. If two or more NRSROs assign ratings to a traded position, the corporate credit union must use the lowest rating to determine the appropriate risk-weight category under paragraph (3)(i).

(B) Non-traded positions. A position that is not traded is eligible for the treatment described in paragraph(3)(i) if:

(1) The position is a recourse obligation, a direct credit substitute, a residual interest, or an asset- or mortgage-backed security extended in connection with a securitization and is not a credit-enhancing interest-only strip;

(2) More than one NRSRO rate the position;

(3) All of the NRSROs that rate the position rate it as no lower than one grade below investment grade (for long term position) or no lower than investment grade (for short term investments). If the NRSROs assign different ratings to the position, the corporate credit union must use the lowest rating to determine the appropriate risk-weight category under paragraph (3)(i) ;

(4) The NRSROs base their ratings on the same criteria that they use to rate securities that are traded positions; and

(5) The ratings are publicly available.

(C) Unrated senior positions. If a recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security is not

rated by an NRSRO, but is senior or preferred in all features to a traded position (including collateralization and maturity), the corporate credit union may risk-weight the face amount of the senior position under paragraph (3)(i) of this section, based on the rating of the traded position, subject to supervisory guidance. The corporate credit union must satisfy NCUA that this treatment is appropriate. This paragraph (3)(i)(c) applies only if the traded position provides substantive credit support to the unrated position until the unrated position matures.

(iii) Consistent use of Ratings Based Approach. A corporate credit union that determines to use the ratings based approach must do so in a consistent manner. For example, if the corporate credit union employs the ratings based approach on at least one security or position on a given call report, the credit union must use the ratings based approach on that call report for every security and position that is eligible for the ratings based approach.

(4) Certain positions that are not rated by NRSROs. (i) Calculation. A corporate credit union may calculate the risk-weighted asset amount for eligible position described in paragraph II(c)(4)(ii) of this section based on the corporate credit union's determination of the credit rating of the position. To risk-weight the asset, the corporate credit union must multiply the face amount of the position by the appropriate risk-weight determined in accordance with Table C of this section.

**Table C**

<b>Rating category</b>	<b>Risk-weight (In percent)</b>
Investment grade	100
One category below investment grade	200

(ii) Eligibility. A position extended in connection with a securitization is eligible for the treatment described in paragraph II(c)(4)(i) of this section if it is not rated by an NRSRO, is not a residual interest, and meets the one of the three alternative standards described in paragraphs (A), (B), or (C) below:

(A) Position rated internally. A direct credit substitute, but not a purchased credit-enhancing interest-only strip, is eligible for the treatment described under

paragraph II(c)(4)(i) of this Appendix, if the position is assumed in connection with an asset-backed commercial paper program sponsored by the corporate credit union. Before it may rely on an internal credit risk rating system, the corporate must demonstrate to NCUA's satisfaction that the system is adequate.

Acceptable internal credit risk rating systems typically:

- (1) Are an integral part of the corporate credit union's risk management system that explicitly incorporates the full range of risks arising from the corporate credit union's participation in securitization activities;
- (2) Link internal credit ratings to measurable outcomes, such as the probability that the position will experience any loss, the expected loss on the position in the event of default, and the degree of variance in losses in the event of default on that position;
- (3) Separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of the particular securitization transaction;
- (4) Identify gradations of risk among "pass" assets and other risk positions;
- (5) Use clear, explicit criteria to classify assets into each internal rating grade, including subjective factors;
- (6) Employ independent credit risk management or loan review personnel to assign or review the credit risk ratings;
- (7) Include an internal audit procedure to periodically verify that internal risk ratings are assigned in accordance with the corporate credit union's established criteria;
- (8) Monitor the performance of the assigned internal credit risk ratings over time to determine the appropriateness of the initial credit risk rating assignment, and adjust individual credit risk ratings or the overall internal credit risk rating system, as needed; and
- (9) Make credit risk rating assumptions that are consistent with, or more conservative than, the credit risk rating assumptions and methodologies of NRSROs.

(B) Program ratings.

(1) A recourse obligation or direct credit substitute, but not a residual interest, is eligible for the treatment described in paragraph II(c)(4)(i) of this Appendix, if the position is retained or assumed in connection with a structured finance program and an NRSRO has reviewed the terms of the program and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal or external credit enhancements and other relevant factors, and the NRSRO specifies ranges of rating categories to them, the corporate credit union may apply the rating category applicable to the option that corresponds to the corporate credit union's position.

(2) To rely on a program rating, the corporate credit union must demonstrate to NCUA's satisfaction that that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The corporate credit union must also demonstrate to NCUA's satisfaction that the criteria underlying the assignments for the program are satisfied by the particular position.

(3) If a corporate credit union participates in a securitization sponsored by another party, NCUA may authorize the corporate credit union to use this approach based on a program rating obtained by the sponsor of the program.

(C) Computer program. A recourse obligation or direct credit substitute, but not a residual interest, is eligible for the treatment described in paragraph II(c)(4)(i) of this Appendix, if the position is extended in connection with a structured financing program and the corporate credit union uses an acceptable credit assessment computer program to determine the rating of the position. An NRSRO must have developed the computer program and the corporate credit union must demonstrate to NCUA's satisfaction that the ratings under the program correspond credibly and reliably with the rating of traded positions.

(5) Limitations on risk-based capital requirements –

(i) Low-level exposure rule. If the maximum contractual exposure to loss retained or assumed by a corporate credit union is less than the effective risk-based capital requirement, as determined in accordance with this Section II(c), for the assets supported by the corporate credit union's position, the risk-based capital requirement is limited to the corporate credit union's contractual exposure less any recourse liability account established in accordance with Generally Accepted Accounting Principles. This limitation does not apply when a corporate credit union provides credit enhancement beyond any contractual obligation to support assets it has sold.

(ii) Mortgage-related securities or participation certificates retained in a mortgage

loan swap. If a corporate credit union holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, it must hold risk-based capital to support the recourse obligation and that percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of risk-based capital required for the security (or certificate) and the recourse obligation is limited to the risk-based capital requirement for the underlying loans, calculated as if the corporate credit union continued to hold these loans as an on-balance sheet asset.

(iii) Related on-balance sheet assets. If an asset is included in the calculation of the risk-based capital requirement under this Section II(c) and also appears as an asset on the corporate credit union's balance sheet, the corporate credit union must risk-weight the asset only under this Section II(c), except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In that case, the corporate credit union must separately risk-weight the on-balance sheet servicing asset and the related recourse obligations and direct credit substitutes under this section, and incorporate these amounts into the risk-based capital calculation.

(6) Obligations of CUSOs. All recourse obligations and direct credit substitutes retained or assumed by a corporate credit union on the obligations of CUSOs in which the corporate credit union has an equity investment are risk-weighted in accordance with this Section II(c), unless the corporate credit union's equity investment is deducted from the credit union's capital and assets under §704.2 and §704.3.

(d) *Collateral*. The only forms of collateral that are recognized for risk-weighting purposes are cash on deposit in the corporate credit union; Treasuries, U.S. government agency securities, and U.S. Government-sponsored enterprise securities; and securities issued by multilateral lending institutions or regional development banks. Claims secured by cash on deposit are assigned to the zero percent risk-weight category (to the extent of the cash amount). Claims secured by securities are assigned to the twenty percent risk-weight category (to the extent of the fair market value of the securities).

## **PART 709 – INVOLUNTARY LIQUIDATION OF FEDERAL CREDIT UNIONS AND ADJUDICATION OF CREDITOR CLAIMS INVOLVING FEDERALLY INSURED CREDIT UNIONS IN LIQUIDATION.**

23. The authority citation for part 709 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766, 1767, 1786(h), 1787, 1788, 1789, 1789a.

24. Revise paragraphs (b)(7) and (b)(9) of §709.5 to read as follows:

§709.5 Payout priorities in involuntary liquidation.

\* \* \* \* \*

(b) \* \* \*

(7) in a case involving liquidation of a corporate credit union, holders of then-outstanding membership capital accounts and nonperpetual capital accounts or instruments to the extent not depleted in a calendar year prior to the date of liquidation and also subject to the capital priority option described in Appendix A of Part 704 of this chapter;

\* \* \* \* \*

(9) in a case involving liquidation of a corporate credit union, holders of then-outstanding paid in capital or perpetual contributed capital instruments to the extent not depleted in a calendar year prior to the date of liquidation and also subject to the capital priority option described in Appendix A of Part 704 of this chapter;

\* \* \* \* \*

**PART 747 -- ADMINISTRATIVE ACTIONS, ADJUDICATIVE HEARINGS,  
RULES OF PRACTICE AND PROCEDURE, AND INVESTIGATIONS.**

25. The authority citation for part 747 continues to read as follows:

Authority: 12 U.S.C. 1766, 1782, 1784, 1786, 1787; 42 U.S.C. 4012a; Pub. L. 101-410; Pub. L. 104-134.

26. Effective [INSERT DATE 12 MONTHS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER], add a new subpart M to part 747 to read as follows:

Subpart M – Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action on Corporate Credit Unions

Sec

747.3001. Scope.

747.3002. Review of orders imposing discretionary supervisory action.

747.3003. Review of order reclassifying a corporate credit union on safety and soundness criteria.

747.3004. Review of order to dismiss a director or senior executive officer.

747.3005. Enforcement of directives.

747.3006. Conservatorship or liquidation of critically undercapitalized corporate credit union.

Subpart M – Issuance, Review and Enforcement of Orders Imposing Prompt Corrective Action on Corporate Credit Unions

§ 747.3001. Scope.

(a) Independent review process. The rules and procedures set forth in this subpart apply to corporate credit unions which are subject to discretionary supervisory actions under Section 704.4 of this chapter and to reclassification under § 704.4(d)(3) of this chapter to facilitate prompt corrective action, and to senior executive officers and directors of such corporate credit unions who are dismissed pursuant to a discretionary supervisory action imposed under Section 704.4 of this chapter. Section 747.3002 of this subpart provides an independent appellate process to challenge such decisions.

(b) Notice to State officials. With respect to a State-chartered corporate credit union under §§ 747.3002, 747.3003 and 747.3004 of this subpart, any notices, directives and decisions on appeal served upon a corporate credit union, or a dismissed director or officer thereof, by the NCUA will also be served upon the appropriate State official. Responses, requests for a hearing and to present

witnesses, requests to modify or rescind a discretionary supervisory action and requests for reinstatement served upon the NCUA by a corporate credit union, or any dismissed director or officer of a corporate credit union, will also be served upon the appropriate State official.

**§ 747.3002. Review of orders imposing discretionary supervisory action.**

(a) Notice of intent to issue directive. --

(1) Generally. Whenever the NCUA intends to issue a directive imposing a discretionary supervisory action under §§ 704.4(k)(2)(v) and 704.4(k)(3) of this chapter on a corporate credit union classified "undercapitalized" or lower, the NCUA will give the corporate credit union prior notice of the proposed action and an opportunity to respond.

(2) Immediate issuance of directive without notice. The NCUA may issue a directive to take effect immediately under paragraph (a)(1) of this section without notice to the corporate credit union if the NCUA finds it necessary in order to carry out the purposes of §704.4 of this chapter. A corporate credit union that is subject to a directive which takes effect immediately may appeal the directive in writing to the NCUA Board (Board). Such an appeal must be received by the Board within 14 calendar days after the directive was issued, unless the Board permits a longer period. Unless ordered by the NCUA, the directive will remain in effect pending a decision on the appeal. The Board will consider any such appeal, if timely filed, within 60 calendar days of receiving it.

(b) Contents of notice. The NCUA's notice to a corporate credit union of its intention to issue a directive imposing a discretionary supervisory action will state:

(1) The corporate credit union's capital measures and capital category classification;

(2) The specific restrictions or requirements that the Board intends to impose, and the reasons therefore;

(3) The proposed date when the discretionary supervisory action would take effect and the proposed date for completing the required action or terminating the action; and

(4) That a corporate credit union must file a written response to a notice within 14 calendar days from the date of the notice, or within such shorter period as the Board determines is appropriate in light of the financial condition of the corporate credit union or other relevant circumstances.

(c) Contents of response to notice. A corporate credit union's response to a notice under paragraph (b) of this section must:

(1) Explain why it contends that the proposed discretionary supervisory action is not an appropriate exercise of discretion under this section;

(2) Request the Board to modify or to not issue the proposed directive; and

(3) Include other relevant information, mitigating circumstances, documentation, or other evidence in support of the corporate credit union's position regarding the proposed directive.

(d) NCUA Board consideration of response. The Board, or an independent person designated by the Board to act on the Board's behalf, after considering a response under paragraph (c) of this section, may:

(1) Issue the directive as originally proposed or as modified;

(2) Determine not to issue the directive and to so notify the corporate credit union; or

(3) Seek additional information or clarification from the corporate credit union or any other relevant source.

(e) Failure to file response. A corporate credit union which fails to file a written response to a notice of the Board's intention to issue a directive imposing a

discretionary supervisory action, within the specified time period, will be deemed to have waived the opportunity to respond, and to have consented to the issuance of the directive.

(f) Request to modify or rescind directive. A corporate credit union that is subject to an existing directive imposing a discretionary supervisory action may request in writing that the Board reconsider the terms of the directive, or rescind or modify it, due to changed circumstances. Unless otherwise ordered by the Board, the directive will remain in effect while such request is pending. A request under this paragraph which remains pending 60 days following receipt by the Board is deemed granted.

**§ 747.3003. Review of order reclassifying a corporate credit union on safety and soundness criteria.**

(a) Notice of proposed reclassification based on unsafe or unsound condition or practice. When the Board proposes to reclassify a corporate credit union or subject it to the supervisory actions applicable to the next lower capitalization category pursuant to § 704.4(d)(3) of this chapter (such action hereinafter referred to as "reclassification"), the Board will issue and serve on the corporate credit union reasonable prior notice of the proposed reclassification.

(b) Contents of notice. A notice of intention to reclassify a corporate credit union based on unsafe or unsound condition or practice will state:

(1) The corporate credit union's current capital ratios and the capital category to which the corporate credit union would be reclassified;

(2) The unsafe or unsound practice(s) and/or condition(s) justifying reasons for reclassification of the corporate credit union;

(3) The date by which the corporate credit union must file a written response to the notice (including a request for a hearing), which date will be no less than 14 calendar days from the date of service of the notice unless the Board determines that a shorter period is appropriate in light of the financial condition of the corporate credit union or other relevant circumstances; and

(4) That a corporate credit union which fails to --

(i) File a written response to the notice of reclassification, within the specified time period, will be deemed to have waived the opportunity to respond, and to have consented to reclassification;

(ii) Request a hearing will be deemed to have waived any right to a hearing; and

(iii) Request the opportunity to present witness testimony will be deemed to have waived any right to present such testimony.

(c) Contents of response to notice. A corporate credit union's response to a notice under paragraph (b) of this section must:

(1) Explain why it contends that the corporate credit union should not be reclassified;

(2) Include any relevant information, mitigating circumstances, documentation, or other evidence in support of the corporate credit union's position;

(3) If desired, request an informal hearing before the Board under this section; and

(4) If a hearing is requested, identify any witness whose testimony the corporate credit union wishes to present and the general nature of each witness's expected testimony.

(d) Order to hold informal hearing. Upon timely receipt of a written response that includes a request for a hearing, the Board will issue an order commencing an informal hearing no later than 30 days after receipt of the request, unless the corporate credit union requests a later date. The hearing will be held in Alexandria, Virginia, or at such other place as may be designated by the Board, before a presiding officer designated by the Board to conduct the hearing and to recommend a decision.

(e) Procedures for informal hearing. -- (1) The corporate credit union may appear at the hearing through a representative or through counsel. The corporate credit union will have the right to introduce relevant documents and to present oral argument at the hearing. The corporate credit union may introduce witness testimony only if expressly authorized by the Board or the presiding officer. Neither the provisions of the Administrative Procedure Act (5 U.S.C. 554-557) governing adjudications required by statute to be determined on the record nor the Uniform Rules of Practice and Procedure (12 CFR part 747) will apply to an informal hearing under this section unless the Board orders otherwise.

(2) The informal hearing will be recorded, and a transcript will be furnished to the corporate credit union upon request and payment of the cost thereof. Witnesses need not be sworn, unless specifically requested by a party or by the presiding officer. The presiding officer may ask questions of any witness.

(3) The presiding officer may order that the hearing be continued for a reasonable period following completion of witness testimony or oral argument to allow additional written submissions to the hearing record.

(4) Within 20 calendar days following the closing of the hearing and the record, the presiding officer will make a recommendation to the Board on the proposed reclassification.

(f) Time for final decision. Not later than 60 calendar days after the date the record is closed, or the date of receipt of the corporate credit union's response in a case where no hearing was requested, the Board will decide whether to reclassify the corporate credit union, and will notify the corporate credit union of its decision. The decision of the Board will be final.

(g) Request to rescind reclassification. Any corporate credit union that has been reclassified under this section may file a written request to the Board to reconsider or rescind the reclassification, or to modify, rescind or remove any directives issued as a result of the reclassification. Unless otherwise ordered by the Board, the corporate credit union will remain reclassified, and subject to any directives issued as a result, while such request is pending.

**§ 747.3004. Review of order to dismiss a director or senior executive officer.**

(a) Service of directive to dismiss and notice. When the Board issues and serves a directive on a corporate credit union requiring it to dismiss from office any director or senior executive officer under §§ 704.4(g) and 704.4(k)(3) of this chapter, the Board will also serve upon the person the corporate credit union is directed to dismiss (Respondent) a copy of the directive (or the relevant portions, where appropriate) and notice of the Respondent's right to seek reinstatement.

(b) Contents of notice of right to seek reinstatement. A notice of a Respondent's right to seek reinstatement will state:

(1) That a request for reinstatement (including a request for a hearing) must be filed with the Board within 14 calendar days after the Respondent receives the directive and notice under paragraph (a) of this section, unless the Board grants the Respondent's request for further time;

(2) The reasons for dismissal of the Respondent; and

(3) That the Respondent's failure to --

(i) Request reinstatement will be deemed a waiver of any right to seek reinstatement;

(ii) Request a hearing will be deemed a waiver of any right to a hearing; and

(iii) Request the opportunity to present witness testimony will be deemed a waiver of the right to present such testimony.

(c) Contents of request for reinstatement. A request for reinstatement in response to a notice under paragraph (b) of this section must:

(1) Explain why the Respondent should be reinstated;

(2) Include any relevant information, mitigating circumstances, documentation, or other evidence in support of the Respondent's position;

(3) If desired, request an informal hearing before the Board under this section; and

(4) If a hearing is requested, identify any witness whose testimony the Respondent wishes to present and the general nature of each witness's expected testimony.

(d) Order to hold informal hearing. Upon receipt of a timely written request from a Respondent for an informal hearing on the portion of a directive requiring a corporate credit union to dismiss from office any director or senior executive officer, the Board will issue an order directing an informal hearing to commence no later than 30 days after receipt of the request, unless the Respondent requests a later date. The hearing will be held in Alexandria, Virginia, or at such other place as may be designated by the Board, before a presiding officer designated by the Board to conduct the hearing and recommend a decision.

(e) Procedures for informal hearing. -- (1) A Respondent may appear at the hearing personally or through counsel. A Respondent will have the right to introduce relevant documents and to present oral argument at the hearing. A Respondent may introduce witness testimony only if expressly authorized by the Board or by the presiding officer. Neither the provisions of the Administrative Procedure Act (5 U.S.C. 554-557) governing adjudications required by statute to be determined on the record nor the Uniform Rules of Practice and Procedure (12 CFR part 747) apply to an informal hearing under this section unless the Board orders otherwise.

(2) The informal hearing will be recorded, and a transcript will be furnished to the Respondent upon request and payment of the cost thereof. Witnesses need not be sworn, unless specifically requested by a party or the presiding officer. The presiding officer may ask questions of any witness.

(3) The presiding officer may order that the hearing be continued for a reasonable period following completion of witness testimony or oral argument to allow additional written submissions to the hearing record.

(4) A Respondent will bear the burden of demonstrating that his or her continued employment by or service with the corporate credit union would materially strengthen the corporate credit union's ability to --

(i) Become "adequately capitalized," to the extent that the directive was issued as a result of the corporate credit union's capital classification category or its failure to submit or implement a capital restoration plan; and

(ii) Correct the unsafe or unsound condition or unsafe or unsound practice, to the extent that the directive was issued as a result of reclassification of the corporate credit union pursuant to § 704.4(d)(3) of this chapter.

(5) Within 20 calendar days following the date of closing of the hearing and the record, the presiding officer will make a recommendation to the Board concerning the Respondent's request for reinstatement with the corporate credit union.

(f) Time for final decision. Not later than 60 calendar days after the date the record is closed, or the date of the response in a case where no hearing was requested, the Board will grant or deny the request for reinstatement and will notify the Respondent of its decision. If the Board denies the request for reinstatement, it will set forth in the notification the reasons for its decision. The decision of the Board will be final.

(g) Effective date. Unless otherwise ordered by the Board, the Respondent's dismissal will take and remain in effect pending a final decision on the request for reinstatement.

#### **§ 747.3005. Enforcement of directives.**

(a) Judicial remedies. Whenever a corporate credit union fails to comply with a directive imposing a discretionary supervisory action, or enforcing a mandatory supervisory action under Section 704.4 of this chapter, the Board may seek enforcement of the directive in the appropriate United States District Court pursuant to 12 U.S.C. 1786(k)(1).

(b) Administrative remedies -- (1) Failure to comply with directive. Pursuant to 12 U.S.C. 1786(k)(2)(A), the Board may assess a civil money penalty against any

corporate credit union that violates or otherwise fails to comply with any final directive issued under Section 704.4 of this chapter, or against any institution-affiliated party of a corporate credit union (per 12 U.S.C. 1786(r)) who participates in such violation or noncompliance.

(2) Failure to implement plan. Pursuant to 12 U.S.C. 1786(k)(2)(A), the Board may assess a civil money penalty against a corporate credit union which fails to implement a capital restoration plan under § 704.4(e) of this chapter, regardless whether the plan was published.

(c) Other enforcement action. In addition to the actions described in paragraphs (a) and (b) of this section, the Board may seek enforcement of the directives issued under Section 704.4 of this chapter through any other judicial or administrative proceeding authorized by law.

**§ 747.3006. Conservatorship or liquidation of critically undercapitalized corporate credit union.**

Notwithstanding any other provision of this title, the NCUA may, without any administrative due process, immediately place into conservatorship or liquidation any corporate credit union that has been categorized as critically undercapitalized.